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TAX FOUNDATION'S VOL. 32, NO. 7 OCTOBER 1988

TAX·FEATURES

Shadow Committee Urges New Budgetary Procedure During Transition

Tax Foundation's Annual Conference Set for November 30 in New York City

The Tax Foundation will convene its 40th National Conference in New York November 30 with "Facing Fiscal Reality" as the conference theme. Dr. Theodore R. Eck, Chief Economist of the Amoco Corporation, will launch the program by assessing the economic outlook for 1989.

A discussion of how Washington manages to evade or avoid fiscal restraint follows, titled "Federal Budget Limitations and Ways Around Them: Government Guarantees, Mandating of Employee Benefits and Hidden Taxes." This panel features: Rudolph G. Penner, senior fellow, Urban Institute, former director, Congressional Budget Office, and a member of Tax Foundation's Shadow Committee on the Federal Budget; Kenneth McLennan, President & Chief Executive Officer, Machinery & Allied Products Institute; and Gary S. Becker, Professor of Economics and Sociology, University of Chicago.

David Gergen, Editor-at-Large of *U.S. News & World Report* and former White House Communications Director, will keynote the luncheon on "The Next Administration Faces Fiscal Reality."

The afternoon session poses: "Is the Income Tax System Becoming Compliance Proof?" The panelists: Ronald A. Pearlman, Chief of Staff, Joint Committee on Taxation; Byrle M. Abbin, Managing Director, Federal Tax Services, Arthur Andersen & Co.; and Don J. Summa, Professor, Graduate School of Management, Rutgers University.

At the 51st Annual Dinner that evening, the Trustees will confer on The Honorable Bill Archer, U.S. Representative from the 7th District of Texas, the Foundation's Distinguished Public Service Award for 1988. As Ranking Minority Member on the Ways & Means Committee, Congressman Archer has been an outspoken proponent of market-oriented tax policy and a fiscally sound social security system.

For conference information, call 202-822-9050

The Shadow Committee on the Federal Budget's mid-September report, entitled "The Budget Calm Before the Deficit Storm," analyzes the current political situation and election campaigns to see what they portend for fiscal policy. It finds pent-up demand for spending in numerous areas: the savings and loan and bank crises; national defense; day care; drug control; welfare reform; and housing programs. Recognizing that the candidates face enormous pressure to endorse the spending initiatives promoted by various interest groups, the Shadow Committee nevertheless sees in the upcoming months an opportunity to ease the Federal budgeting impasse. To this end the Shadow Committee prescribes structural changes in the Federal budgeting process which, if implemented during the transition period, could break the policy deadlock that has paralyzed budgetmaking.

The report begins by comparing OMB and CBO deficit projections, alarming in themselves, but all the more so in that they allow for no new spending initiatives. It is this crunch between pent-up demand for spending on one side and the budget deficit on the other that the first two recommendations address, urging the candidates not to make unrealistic spending promises, and to spell out a plan to cope with the deficit.

Permanent Changes Needed

The last two recommendations are concrete proposals for permanent change in the budget process:

- Beginning with this presidential transition, the outgoing President should submit a budget consisting solely of current service estimates.
- The incoming President should submit a four-year fiscal policy framework, with appropriate budget detail for the first year, aimed at a balanced budget by the end of his term of office. He should be provided with sufficient transitional staff for this purpose.

The report is available for $4 plus $1 p/h from Tax Foundation, One Thomas Circle, N.W., Suite 500, Washington, DC 20005.

The Shadow Committee on the Federal Budget is an independent citizens' watchdog group acting under the auspices of the Tax Foundation, a Washington-based fiscal policy research organization. Members include Chairman Leif H. Olsen, The Honorable Harry F. Byrd, Jr., W. Bowman Cutter, Paul H. O'Neill, Rudolph G. Penner, and Allen Schick.

THIS ISSUE:

PAGE 1:
Shadow Committee Annual Conference
PAGE 2:
Tax Index
PAGE 3:
"Budget Watch"
PAGE 5:
"Front Burner" OECD Nations' Taxes
INSERT:
S&L and Bank Crisis

Tax Index Reaches Record Level As 1st Quarter 1988 Taxes Rise $110.9 Billion

The Tax Index climbed to a record level of 640.6 (1967=100) in the first quarter of 1988, representing $1.419 trillion in taxes at an annual rate. First quarter 1988 tax receipts were up $110.9 billion or 8.5 percent over first quarter 1987 and are almost six and one-half times their 1967 base year level.

The Tax Index is a fiscal yardstick designed by Tax Foundation economists to provide a continuing current measure of trends in taxes at the Federal, state and local government levels. For 1988, both Federal and state/local tax increases fueled the 23.2 point jump in the overall Tax Index. The Federal Tax Index at 621.5 showed a 3.7 percent annualized increase over 1987 and represents $934.8 billion in tax revenues. The state/local Tax Index increased at a slightly faster 3.8 percent annual rate mirroring a 1988 tax take of $481.1 billion.

Tax Growth Outpaces GNP

Since the trough of the recession (fourth quarter 1982), the Tax Index has risen from 421.4 to 640.6 or 52 percent. Federal taxes have gone up a hefty 49.9 percent, and state/local taxes increased even faster at 56.2 percent. The 52 percent rise in taxes slightly outpaced the 49.2 percent gain in GNP over the same period.

Social Insurance Taxes Dominate

By far the fastest growing tax as measured by the Tax Index has been contributions for social insurance, now almost ten times their 1967 level. Personal income taxes ranked second, approaching seven times their 1967 level. The Federal personal income Tax Index reflects tax reductions resulting from the Economic Recovery Tax Act of 1981 (ERTA); however, the state/local personal income Tax Index increased consistently during the same period.

Corporate Taxes Rise Fastest Since Recession

Examination of the Tax Index since the 1982 trough of the recession reveals corporate profit taxes increasing a whopping 117.2 percent from an index of 193.3 in 1982 to 419.9 by 1988—far outpacing the growth in all other sources of tax revenues. Other significant increases for this period are seen in social insurance contributions, up 60.7 percent and indirect business taxes (sales, excises, custom and real property taxes), up 45.9 percent.

'80s: Slower Tax Growth Than '70s

In the 1980's, overall taxes have risen an average of 7.6 percent per year, however, this rate of increase is slower than the average 10 percent yearly increases witnessed during the 1970s. Federal taxes, which increased an average of 9.9 percent per year in the 1970s, have averaged 7.2 percent annual increases since 1980. State and local tax increases have also slowed in this decade from yearly increases averaging 10.2 percent in the 1970s to 8.1 percent annual increases in the 1980s. See the accompanying table for further detail.

Tax Index (1967=100)

Total, Federal, and State and Local

Selected Periods 1970-1988

Calendar Year and Quarter	Total All Taxes	Personal Income Taxes	Corporate Profit Taxes	Indirect Business Taxes[a]	Social Insurance Contributions	All Other Taxes[b]
	Total Government Tax Index					
1970	132.5	141.4	105.2	134.7	136.0	124.6
1975	205.4	203.3	156.1	199.4	260.8	167.7
1980	363.8	416.6	260.1	295.4	479.3	233.8
1981	414.7	481.7	248.8	347.4	556.8	247.7
1982	421.4	494.2	193.3	355.1	596.6	267.7
1983	445.6	491.3	236.8	366.7	644.4	250.8
1984	491.9	526.7	288.0	427.0	718.7	261.5
1985	532.7	583.7	296.0	453.0	783.3	281.5
1986	564.2	610.5	327.0	476.0	836.9	304.6
1987	617.4	685.0	410.1	500.1	883.1	326.2
1988 I[c]	640.6	688.2	419.9	518.2	958.6	329.2
	Federal Tax Index					
1970	128.0	137.9	102.0	119.7	135.8	119.4
1975	193.2	187.6	145.3	146.1	262.6	158.1
1980	362.4	389.9	234.3	223.7	485.7	212.9
1981	418.5	453.0	219.0	330.9	569.5	225.8
1982	414.6	460.4	163.3	271.7	607.7	245.2
1983	430.7	447.4	204.3	295.4	656.8	190.3
1984	473.4	471.6	250.7	316.4	739.8	196.8
1985	514.3	526.2	254.3	307.9	808.0	209.7
1986	541.7	549.1	279.7	292.8	863.7	229.0
1987	599.2	616.1	352.7	310.5	912.5	238.7
1988 I[c]	621.5	614.8	357.3	321.7	996.6	229.0
	State and Local Tax Index					
1970	141.9	178.7	142.3	139.0	137.3	129.4
1975	232.1	368.9	280.8	214.9	250.7	176.5
1980	366.8	698.4	557.7	316.3	443.3	252.9
1981	406.6	785.2	592.3	352.2	485.1	267.6
1982	435.9	850.8	538.5	379.3	534.3	288.2
1983	477.1	955.7	611.5	413.2	574.6	305.9
1984	530.9	1,108.2	719.2	459.1	600.0	320.6
1985	571.6	1,183.6	776.9	495.2	644.8	347.1
1986	611.8	1,259.0	873.1	529.3	686.6	373.5
1987	655.8	1,411.5	1,073.1	555.3	717.9	405.9
1988 I[c]	680.9	1,463.9	1,142.3	575.3	744.8	420.6

[a] Sales, excises, customs levies and real property taxes.
[b] Estate and gift and personal property taxes.
[c] Seasonally adjusted annual rate.
Source: Tax Foundation computations based on data from U.S. Department of Commerce, Bureau of Economic Analysis.

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FEDERAL TAX POLICY MEMO

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OCTOBER 1988

Time Bomb for Taxpayers: Federal Credit Losses

by John Hanly Adams
Editorial Consultant

A financial and political time bomb waiting for the next President and the new 101st Congress: What to do about chaotic mismanagement and potential heavy losses in Federal credit empires and Federally-insured financial institutions.

Bailing out failed savings and loan institutions and savings banks whose deposits up to $100,000 are insured by the Federal Savings and Loan Insurance Corporation (FSLIC or "Fizzlick") and the Federal Deposit Insurance Corporation (FDIC) has attracted wide attention. But that's only part of the story.

One of the unloveliest features of this orphan crisis—neither presidential candidate mentioned it in the early stages of the '88 election campaign—is that nobody seems to have a clue as to the ultimate dimensions of the Bailout Bomb.

Guesses as to the final cost to taxpayers of rescuing FSLIC alone range from $20 billion to $100 billion. Other billions are being lost in defaulted direct Federal loans andFederally guaranteed private loans. And losses incurred so far would be a drop in the bucket if a full-blown recession, which some economists predict will start in late 1989 if not sooner, pushes thousands of individuals and institutions over the brink into bankruptcy.

In such a financial washout, a host of Federal credit liabilities could be presented for additional infusions of Federal capital and eventually massive write-offs of losses at taxpayer expense. Largest of Washington's "contingent liabilities" are the $1.6 trillion in insured FDIC bank accounts and $836 billion in FSLIC accounts. Other guarantees and insurance schemes bring the total to $4 trillion, plus.

Having to cope with all those liabilities at one time has been considered "unthinkable" for decades; sort of like nuclear war. Yet there seems to a gathering consensus even on Capitol Hill, the Mother Lode of Liabilities, that the present disorders in federal budgeting, spending and lending and accounting, cannot go on much longer.

Fizzlick: Underwater

If the FSLIC were a private bank it would be in bankruptcy, but it's not. So it stays in business, papering over its losses and counting on Congress to absorb the final cost of S&L failures. As the Congressional Budget Office said in an August 1988 report: "No one knows the timing or amount of spending that will be needed to deal with insolvent financial institutions."

At last count, 500 of the approximately 3,000 savings and loan institutions with FSLIC backing were insolvent, unable to meet operating expenses including premiums owed to FSLIC's trust fund, which is supposed to pay off depositors when institutions go belly up.

Trust fund outgo began to exceed income in the early 1980s

"Serious Weaknesses . . . Ineffective Managers"

A report on federal credit problems from The President's Commission on Privatization in March 1988 —

■ The Federal government lends more funds each year than any other financial institution in the world. Its $250 billion loan portfolio exceeds in value the combined portfolios of the nation's two largest commercial banks. In addition, the federal government currently guarantees $450 billion worth of outstanding loans issued by private lenders. Approximately 15 percent of all credit originated in the United States between 1981 and 1986 was either issued, or insured, by the Federal government.

■ "There is broad agreement that federal lending agencies have been ineffective as loan managers."

■ The delinquency rate on federal loans is eight percent, about three times that on private loans. The government is owed more than $24 billion on delinquent loans. The Guaranteed Student Loan Program's defaulted loans will reach an estimated $12 billion by 1990.

■ A 1986 Government Accounting Office report charged that "financial statement audits, as well as inspector general reviews, have consistently disclosed serious weaknesses in agencies' systems . . . " A later GAO report on Housing and Urban Development revealed that 20 percent of HUD's sampled loan files were "completely missing or missing key documents such as mortgage contracts."

■ Federal agencies do not write off their bad loans, as private banks generally must do, thus overstating the real value of government loan portfolios. The Export Import Bank still lists at face value $89 billion in loans made to pre-Castro Cuba in the 1950s.

■ The Federal budget understates the actual cost of direct U.S. loans, thus encouraging policy makers "to divert Federal resources into the credit portion of the budget so as to minimize the perceived effect of their actions on the budget deficit. . . . Accounting for federally guaranteed loans has become an even more refined form of budgetary distortion. Loan guarantees, because they do not involve an immediate cash payment, are treated as if they were free to the taxpayer, even though they place a sizable contingent liability on the taxpayers' shoulders."

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when an interest rate explosion put many S&Ls in a bind: Outstanding loans paid low rates while new deposits could be had only by offering high rates.

Federal secondary market operations such as "Ginnie Mae" absorbed billions of lower-paying mortgages but even that could not save some badly—and corruptly—managed S&Ls. Then came the devastation of recessions in the farm belt, the "rust belt" and the "oil patch" of the Southwest, bringing waves of real estate foreclosures and the consequent collapse of market values.

The FSLIC trust fund was drained of its reserves by the end of 1986 and had a "negative balance" of nearly $12 billion by the end of 1987. Congress came through with a "temporary" infusion of $10.8 billion in mid-summer 1987, in the form of authority to issue that amount of long-term bonds.

More Money Needed

Many more billions will be needed to put sick S&Ls out of their misery by closing them down and selling their assets, including loan portfolios, to stronger institutions via merger or outright sale, or by propping them up with Federal loans until they can work their way out of their holes. Any of the alternatives will be expensive, at least for the short run, for stockholders and the government.

The wringing out process, well under way by mid-1988, is controlled by Federal regulators working for the Federal Home Loan Bank Board, which governs S&Ls that are Federally chartered. Analysts have faulted the FHLBB for not acting faster to shut down money-losing institutions. And when the regulators do force a "case resolution," some of the deals are criticized as too favorable to the buyers of the failed outfit.

Only time will tell how much of a beating the FHLBB, acting for the taxpaying public, is going to take. Based on experience in 1987 the General Accounting Office in March 1988 estimated it would cost about $26 billion to purge S&Ls. On September 15, the GAO said a recheck indicated at least $45 to $50 billion would be required, "given the higher-than-anticipated cost of dealing with each and every institution that we have either closed, merged, or tried to deal with." Some private experts believe the cost will reach $100 billion.

Exactly how the rescue dollars will be raised is an active issue in Congress and the S&L industry. The healthy institutions argue they cannot bear the burden alone, through higher premiums paid into the insurance trust fund or by raising new investor capital for ailing members. Their allies on Capitol Hill seem sympathetic.

Temporarily, the FSLIC is issuing promissory notes to finance its operations until reserves can be rebuilt. As of early autumn 1988, more than $11 billion of such notes had been issued and questions were being raised as to whether they had the "full faith and credit" of the U.S. Treasury behind them — essential for their marketability. The Treasury said the notes issued to date were okay but Congress is skittish about making that a blank check for the indefinite future.

A final answer, acceptable to all, is unlikely before next spring when Congress and a new administration will have to grapple with the many issues involved in S&L sicknesses.

FDIC: Hit But Healthy

By contrast with S&L deposit insurance, the system for banks, run by the Federal Deposit Insurance Corporation, is in good shape. As FDIC's 1987 annual report put it:

"The FDIC ended 1987 with a small increase—$48.5 million—in net worth, despite record numbers of bank failures and assistance transactions and record outlays in handling them, increased fraud against banks, depressed regional economies and the repercussions of Black Monday (stock market crash of October 19, 1987). The FDIC fund remains healthy at $18.3 billion, about the same level as last year."

That is all the more impressive in view of the battering taken by banks in the 1980s from two directions: The farm and oil debacles, which hit banks as hard as S&Ls and sometimes harder; and the added blows to banks from soured loans to Third World countries.

The result was that 2,366 of the 13,654 FDIC-insured banks lost money in 1987. The industry's net profit declined from $17.5 billion in 1986 to $3.7 billion in 1987, a return on assets of 0.13 percent, lowest since 1934.

During 1987, 203 insured banks were closed or kept open only with emergency aid, at a cost to FDIC estimated at $2.1 billion. As of December 31, 1987, 1,599 insured banks were on the "problem bank" list, nearly four times the number at the end of 1982.

FDIC net operating income, $1 billion a year from 1980 to 1985, slipped to less than $300 million in 1986, then to $50 million in 1987. A loss may occur in 1988, the way things are going. Some big bailout losses are being taken, estimated at $2 billion on one Texas bank deal alone.

Another worry: The FDIC insurance fund, while still over $18 billion, is not keeping up with the increase in insured deposits that reflects the economy's growth. The ratio of insurance to deposits has declined from 1.24 percent at the end of 1981 to 1.1 percent at the end of 1987—the lowest ratio in FDIC history.

FDIC officials insist that "the high water mark for bank failures will be reached this year (1988) . . . The number of banks on the FDIC's internal watch list has been falling . . . the FDIC has more than $15 billion in cash reserves to handle problems in the banking system—problems we believe have peaked." Longer range political trends may be creating new problems, however.

Overdosing on Guarantees

Political leaders of both parties are advocating, in the 1988 election, new spending programs to be launched with government guaranteed credi. That works until confidence, in the U.S. and abroad, is eaten away by too many debacles. The basic problem is that when Uncle Sugar gets involved, too many players use credit unwisely, assuming they can walk away if the going gets tough, with the taxpayers picking up the tab. That is happening in many of the FSLIC cases to date. It may be a warning that restraint, rather than expansion, of federal credit is a true imperative now.

Budget Watch By Allen Schick

The Disappearing Impoundment Power

Once upon a time, Presidents used impoundments to control federal spending; nowadays, Congress uses the impoundment power to control the President. This role reversal has a lot to do with the huge deficits that beset the federal budget.

For most of American history, Congressional appropriations were deemed to limit the amount that could be spent by Federal government agencies. There was no requirement that they use all the money; if they didn't, the unspent funds were impounded and returned to the Treasury. Today, however, appropriations are often considered mandates to spend available funds. If an agency doesn't want to use the money, Congress can exercise its impoundment controls and compel it to make the expenditure. In fact, the impoundment controls are rigged to force more spending than the executive branch wants.

The Basic Rules of Impoundment

Prior to 1974, there were no established procedures for congressional review of presidential impoundments. From time to time, the two branches clashed over the question of whether appropriated money had to be spent. One such battle occurred in the early 1970s when President Nixon withheld billions of dollars provided by Congress. In response to what it regarded as Nixon's improper actions, Congress passed the Impoundment Control Act of 1974 (ICA) which provides statutory rules for congressional review of impoundments.

> ***" . . . appropriations are often considered mandates . . . If an agency doesn't want to use the money, Congress can . . . compel the expenditure."***

ICA divides impoundments into two categories and prescribes different rules for each. A *rescission* cancels previous appropriations; a *deferral* delays use of the funds. Every impoundment is classified as either a rescission or a deferral; it cannot be both or something else.

To rescind funds, the President must submit a proposal to Congress specifying the amount to be cancelled, the affected programs, and the reasons for not spending the money. Congress then has 45 days of "continuous session" (usually a larger number of calendar days) during which it may pass a rescission bill. This bill may cancel all, part, or none of the amount proposed by the President. If Congress does not rescind the funds by the end of the 45-day period, the President must make the money available for expenditure. This means congressional inaction compels release of the funds.

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The deferral rules have become increasingly restrictive; in their current form, they severely limit presidential power. As originally devised by the 1974 ICA, a deferral of funds remained in effect unless it was disapproved by either the House or the Senate. Thus, unlike rescissions, deferrals were upheld by congressional inaction. But funds could not be deferred beyond a single fiscal year or for a period of time that would cause the money to lapse.

In 1983, the U.S. Supreme Court ruled that all legislative vetoes (including congressional disapproval of deferrals) violate the constitutional separation of powers. As a result, Congress no longer had a means of forcing the President to release deferred funds. In response to this situation, Congress, in its 1987 revision of the Gramm-Rudman-Hollings law, took away the President's power to make "policy deferrals," that is, deferrals whose purpose is to reduce the program level or alter governmental policy. At present, the President is restricted to routine deferrals authorized by the Antideficiency Act. These deferrals occur only when programs can accomplish their objectives without using the full amount provided for them. Ronald Reagan is the first President in U.S. history barred by law from deferring funds in order to slowdown federal spending or reduce the deficit.

Congressional Review of Impoundments

Impoundment is a barometer of the political relationship between the White House and Capitol Hill. When the President dominates the relationship, Congress tends to accept his impoundments; when Congress is dominant, it often rejects them.

It should come as no surprise, therefore, that each of the presidents who has operated under the 1974 impoundment control rules has had a different success rate. As displayed in the table accompanying this article, Gerald Ford, Jimmy Carter, and Ronald Reagan tried to rescind a total of more than $57 billion in appropriated funds and to defer another $167 billion. Ford won approval of only 7 percent of his rescissions; by refusing

(Continued on page 4)

(BUDGET WATCH, *from page 3*)

to act, Congress compelled him to release more than 90 percent of the dollars he sought to cancel. Carter, who, unlike Ford, faced a Congress controlled by his political party, was more successful. Still, he obtained approval of less than 40 percent of his proposed rescissions. Reagan's overall approval rate for rescissions (38 percent) is almost the same as his predecessor's, but the data reveal a remarkable difference between his first two years in office and subsequent years. In 1981 and 1982, President Reagan prevailed on Congress to cancel $16 billion in appropriations. Since 1983, however, Congress has rescinded only $400 million. In percentage terms, Reagan won adoption of a niggardly 2 percent of proposed rescissions in the 1983-88 years, compared to 69 percent in 1981 and 1982.

Recent Presidents have been more successful in deferring funds, but there is a marked difference between routine deferrals and those done for policy reasons. Congress has acceded to more than 99 percent of routine deferrals but has gone along with only slightly more than half of policy deferals. Here, too, President Reagan was much more successful in his first two years than in the next six. More than 90 percent of the policy deferrals made in 1981-82 were accepted by Congress, compared to only 35 percent in subsequent years. No policy deferrals were proposed for 1988, the first time since the Impoundment Control Act of 1974 that this type of impoundment was not used.

Ronald Reagan is the first President in U.S. history barred by law from deferring funds in order to slow down federal spending or reduce the deficit.

Restoring Impoundment Power

A number of proposals have been made to strengthen the President's authority to impound funds. President Reagan has requested "enhanced rescission authority" which would permit the continued impoundment of funds unless Congress expressly rejects the proposed rescission. The President has argued that this power would enable him to reduce spending and the deficit by eliminating wasteful expenditures.

Enhanced rescission authority would make the President a stronger participant in the budget process. His rescissions would remain in effect if Congress failed to muster a majority against them. Unlike the present situation, the President—not Congress—would prevail in case of legislative inaction. The outcomes of rescissions and deferrals proposed since 1975 provide conclusive evidence that the branch that prevails in case of legislative inaction has the upper hand.

The impoundment power goes to the heart of the budgetary relationship of the President and Congress. Presidential success in impoundment depends not only on rules and procedures, but also on the Chief Executive's political standing. Despite the fact that the ICA rules terminate rescissions in case of inaction, President Reagan obtained $16 billion of rescissions in 1981 and 1982. A popular President, armed with strong public support, can exercise the impoundment power effectively. When the President's budget status weakens, so too does his impoundment power.

Rescissions and Deferrals
1975 - 1988
(dollars in millions)

Rescissions	Proposed	Accepted[a]	Percent Accepted
Ford Rescissions	$ 7,405	$ 530	7.2%
Carter Rescissions	6,946	2,580	37.1
Reagan Rescissions (1981-82)	23,269	16,079	69.1
Reagan Rescissions (1983-88)	20,011	400	2.0
Total Reagan Rescissions	43,280	16,479	38.1
Total Rescissions	57,631	19,589	34.0
Policy Deferrals[b]			
Ford Deferrals	$ 23,904	$ 14,145	59.2%
Carter Deferrals	12,905	7,314	56.7
Reagan Deferrals (1981-82)	6,788	6,174	91.0
Reagan Deferrals (1983-88)	22,333	7,736	34.6
Total Reagan Deferrals	29,121	13,910	47.8
Total Policy Deferrals	65,930	35,369	53.6
Routine Deferrals			
Ford Deferrals	$ 16,623	$ 16,610	99.9%
Carter Deferrals	17,943	17,928	99.9
Reagan Deferrals (1981-88)	66,807	66,274	99.2
Total Routine Deferrals	101,373	100,810	99.4

[a] For rescissions, accepted means that Congress passed legislation rescinding the funds; for deferrals, accepted means that Congress did not disapprove the deferral.
[b] Routine deferrals are those authorized under the Antideficiency Act; all others are classified as policy deferrals.
Source: U.S. Office of Management and Budget.

Tax Features

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Tax Structures Vary Greatly Within OECD

Despite numerous economic and political ties, member nations of the Organization for Economic Cooperation and Development (OECD) display great disparity in how they structure their respective tax systems.

In 1986 (latest reported), the share of revenue raised by individual and corporate income taxes ranged from 17 percent in Greece to 70 percent in New Zealand and 56 percent in Denmark. Nations which collect a very small part of their revenues from social security taxes or none at all tend to derive a large share of their revenues from taxes on income.

Income taxes furnish about 39 percent of tax revenue in the 23 OECD countries combined. The U.S. share—42 percent—ranks ninth highest.

France and Greece raised the least through individual income taxes, both at 13 percent. In contrast, New Zealand derived 63 percent of its tax collections from this source. Denmark and Finland also raised only a little less than half of their revenues from individual income taxes. The United States, ranked seventh among the member countries, raised 35 percent of all revenues through the personal income tax.

Corporate profits tax levies also generate significant public revenue for most of the member countries. Japan raised over one-fifth of its 1986 receipts by taxing corporate incomes, ranking highest among the OECD nations. Seven percent of total tax receipts were derived from corporate income taxes in the United States in 1986, close to the OECD average of 8 percent. At the low end, Austria and Ireland raised slightly over 3 percent of their revenues by taxing corporate income.

Taxes on goods and services (sales or consumption levies) are second to income taxes as revenue-raisers in the OECD countries. They provide an average of 30 percent of tax revenues. Governments in the United States raise just under 18 percent of total

(Continued on page 6)

THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

"Social Security: A Devil's Dictionary"

Federal spending on Social Security (OASDHI) for fiscal year 1989 is estimated to top the $300 billion mark, claiming over one-fourth of Federal spending. This is larger than the national budgets of most nations on the planet. Yet, many of us are unclear about even the basic vocabulary needed to follow intelligently the national debate on this enormously costly program. The following definitions are offered in the hope that they will add light—and, perhaps, a chuckle or two—to the discussion:

COLA—Not a soft drink, but the automatic annual jump in social security and other benefits, to offset inflation. Capping the COLA's growth at something like 1 percent less than the growth of the Consumer Price Index (CPI minus 1) would save billions of dollars; but it would also alienate millions of older voters, so Congress and the White House won't touch this hot potato.

Long-Term Care—If you think Medicare is expensive now, wait until this baby comes on stream. That's why the Congress wouldn't even debate the issue in this election year. Look for a stepped-up effort next year.

Medicare—The health insurance portion of Social Security. This is the runaway winner in growth of all the pieces of the Social Security pie-chart—27 times larger than when health insurance was conceived in 1967. Financial pressures on and expansion of this system have led to higher **Premiums**, and **Income-Based Premiums**—really income taxes.

These are ploys the politicians use so that they can continue to distribute goodies and claim credit for largesse, while simultaneously passing the costs back to you the taxpayer. Most of the time, they don't even have to call them tax increases. These gimmicks perform a double service: They make Congress look more generous, and they mask your real costs for government-provided (i.e., taxpayer funded) health insurance.

Social Contract—What most Americans thought social security was. As program costs rise, politicians are cooling their rhetoric and reminding us that Social Security was never intended to be a total national pension system, but only base income support.

Surplus—What is supposed to exist now in the so-called trust funds. It's merely an accounting "surplus"—not even as real as the surplus that exists in your checking account between the day you deposit money in the account and the day you write checks against the total amount you have deposited. There is no true surplus, but this won't keep the politicians from trying to spend it.

Trust Fund—The account where payroll deductions are supposed to be deposited after they leave your paycheck. In reality, there is no real trust fund. Uncle Sam spends your payroll taxes on social security checks or medicare payments. Whatever is left over in effect is used to pay for the government's spending programs.

Welfare Component—Having "cancelled" the contract, Washington next told us that most of what retirees get from Uncle Sam is the "welfare" component that kicks in once they have received back earnings witheld in the payroll tax. This pleases neither the oldsters who feel they have paid into the system all their lives and now are entitled to whatever they can collect, nor young workers who fear the system will go broke before they get any social security benefits.

A34. Percentage Distribution of Tax Revenues in Selected Countries by Source

Fiscal Year 1986

Country	All taxes	Taxes on income and profits[a]		Social Security taxes			Taxes on goods and services			Property taxes[d]	Other and unallocable[e]	Total tax as a % of GDP	Per capita taxes[g]
		Individual income	Corporate profits	Total[b]	Employers' share	Employees' share	Total[c]	General	Specific				
Australia	100.00%	46.6%	9.0%	-	-	-	30.5%	7.8%	18.5%	8.0%	5.5%	31.4%	$ 3,419
Austria	100.00	23.4	3.4	31.9%	15.8%	13.3%	32.1	20.7	10.2	2.4	6.8	42.6	5,281
Belgium	100.00	33.7	6.6	33.6	17.3	13.7	24.0	15.5	6.8	1.9	0.2	45.4	5,302
Canada	100.00	37.0	8.1	13.7	8.7	4.8	29.7	14.6	11.4	9.4	2.1	33.2	4,820
Denmark	100.00	47.8	6.2	3.1	1.2	1.8	35.4	19.5	14.7	4.7	2.8	50.6	8,151
Finland	100.00	48.1	3.7	9.0	9.0	-	35.8	21.5	13.9	3.1	0.3	38.4	5,499
France	100.00	13.0	5.1	42.7	27.4	11.9	29.4	19.5	8.9	4.8	5.0	44.2	5,802
Germany	100.00	28.6	6.0	37.2	19.1	18.1	25.2	15.3	8.6	3.1	-	37.5	5,484
Greece	100.00	13.1	4.0	32.6	14.3	13.7	45.4	17.0	24.4	2.7	2.2	35.7	1,461
Ireland	100.00	32.6	3.5	14.2	9.1	5.0	44.1	20.8	21.4	3.9	1.7	40.2	2,781
Italy	100.00	28.0	9.9	34.3	24.6	6.5	24.6	14.6	8.6	2.7	0.5	36.2	3,798
Japan	100.00	25.1	20.7	29.8	15.4	10.9	13.4	-	11.4	10.9	0.1	28.8	4,698
Luxembourg	100.00	28.5	16.7	25.6	13.8	10.3	24.5	13.3	10.5	6.2	0.5	42.4	6,540
Netherlands	100.00	20.3	7.3	42.5	17.3	18.1	26.0	16.5	7.3	3.6	0.3	45.5	5,483
New Zealand	100.00	62.6	7.0	-	-	-	26.9	12.9	13.2	1.7	1.3	32.9	2,775
Norway	100.00	22.8	13.3	22.2	14.9	6.5	38.8	19.7	17.8	2.1	0.8	49.8	8,346
Portugal	100.00	f	f	28.1	18.5	8.5	48.0	21.0	25.7	1.9	22.0	32.4	968
Spain	100.00	17.7	5.9	39.1	29.4	6.9	32.0	18.0	13.4	3.2	2.1	30.4	1,798
Sweden	100.00	38.0	4.7	25.0	24.1	-	24.8	13.4	10.2	2.8	4.7	53.5	8,385
Switzerland	100.00	34.9	6.2	31.6	9.9	10.0	18.8	9.3	8.1	8.4	0.1	32.6	6,707
Turkey	100.00	26.9	12.1	12.8	7.5	4.3	31.5	23.0	8.0	3.3	13.4	22.7	259
United Kingdom	100.00	27.9	10.3	17.9	9.1	8.2	30.9	15.5	13.7	12.9	0.1	39.0	3,762
United States	1d00.00	35.4	7.0	29.8	17.3	11.5	17.5	7.6	7.5	10.3	-	28.9	4,944

[a] Includes taxes on capital gains.
[b] Includes taxes on self-employed.
[c] Includes import duties, profits on public fiscal monopolies, licenses, and other business taxes.
[d] Includes taxes on movable and immovable property, net wealth taxes, and estate and gift taxes.
[e] Includes general and selective taxes on payrolls which are not earmarked for social security purposes, and other taxes not elsewhere classified.
[f] Income and profit taxes are 21.2% of total taxes and are included under other and unallocable, as they are not segregable between individuals and corporations.
[g] In U.S. dollars.
Source: Organization for Economic Cooperation and Development.

(OECD, *from page 5*)

receipts from such taxes, placing the U.S. 22nd among the 23 OECD members in terms of reliance on consumption taxes.

The major industrialized countries' tax systems can also be compared by examining the size of their tax receipts in relation to economic production.

The ratio of tax revenues to gross domestic product averages 38 percent in OECD countries. By this measure, Sweden is the "most taxing" nation, with receipts coming to just over 53 percent of GDP in 1986. U.S. taxes in 1986 came to 29 percent of GDP, placing this country 21st among its OECD affiliates. Only Japan, with slightly under 29 percent, and Turkey, with 23 percent, ranked lower than the U.S.

The table above provides further details on the distribution of tax revenues in selected countries for fiscal year 1986.

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TAX FOUNDATION'S VOL. 32, NO. 8 NOVEMBER/DECEMBER 1988

TAX·FEATURES

James Riordan of Mobil Corporation Elected as Chairman of Tax Foundation's Board

Archer Urges Bipartisanship and Aggressive Action to Confront Deficit

"We will have an opportunity . . . perhaps only a brief one early in the year," Congressman Bill Archer told Tax Foundation's 51st annual dinner in New York November 30, "to take control of the situation and confront the problem of the federal deficit head on." At the dinner, Representative Archer received the Tax Foundation's Distinguished Public Service Award for 1988 from incoming Board Chairman James Q. Riordan of Mobil Corporation.

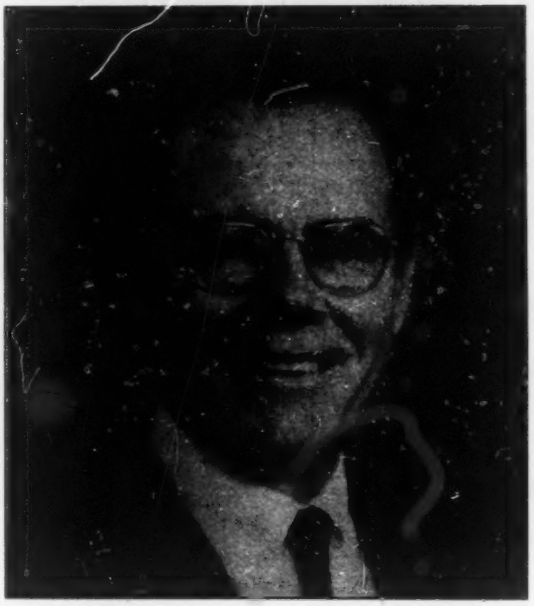
The penalty for failing to deal early with the deficit, the Ranking Republican on the Ways and Means Committee warned, is that "we'll likely face the consequences of having fiscal events control us . . . rather than the other way around."

> ***"We will have an opportunity . . . perhaps only a brief one early in the year, to take control of the situation and confront the deficit head on."***

To avoid what he called "a collision course with fiscal reality," Archer urged the Congress and the Administration to "set aside the rhetoric and demagoguery of election-year politics—and join together in dealing with the reality of a problem which cries out for a bipartisan solution." The Texas Congressman cited a number of factors that he predicted would "generate enormous budgetary pressure":

- "The removal of the Social Security trust funds (and their deficit-masking reserves) from the unified federal budget."
- "The unfunded liability of FSLIC over the next several years."
- "The Department of Energy's cleanup and

(Continued on page 2)



James Q. Riordan

James Q. Riordan, Director, Vice Chairman, and Chief Financial Officer of Mobil Corporation, was named Chairman of the Tax Foundation's Board of Trustees at the Foundation's November 30 Board meeting in New York on November 30. In announcing his election, out-going Chairman Hans W. Wanders of The Wachovia Corporation described Riordan as "a man superbly prepared for the job, with service in both the Executive and Legislative Branches of the Federal Government, the law and the tax and financial sides of a major corporation."

Riordan joined Mobil Oil in 1957, after a varied career that included service on the staff of the House Ways and Means Committee, the Tax Division of the Justice Department, the office of the U.S. Attorney for the Southern District of New York, and private practice with several New York law firms. He became a trustee and member of the executive committee of the Tax Foundation in 1984.

"Having workerd with him closely for the last four years," Wanders told the business executives and press attending the Foundation's annual dinner, "I can assure you that the Foundation is fortunate to have an individual of his competence and dedication to lead it."

THIS ISSUE:

PAGE 1:
Riordan Named Chairman
Archer Speech
PAGE 3:
"Budget Watch"
PAGE 5:
"Front Burner"
Base Closing
INSERT:
Annual Subject Index

(ARCHER, *from page 1*)
modernization of nuclear weapons production facilities."

• "The Department of Defense's hazardous waste cleanup program."

"Our resolve is going to be sorely tested," he cautioned.

Archer went on to describe the confrontation built in to President-elect Bush's no tax pledge and the determination of House Speaker Jim Wright that he will "insist on tax increases." Furthermore, Archer noted, the Democratic leadership will insist that the President "be the first to make the tough choices." He added, "The resolution of these diametrically opposed viewpoints—along with the political implications involved—is obviously the crux of the issue we face in 1989."

Archer described himself as equally opposed to tax increases and as sharing the incoming President's conviction that "federal spending remains the villain in the federal deficit story." He also indicated, however, that"given the majorities which now control the House and Senate . . . I don't think we can win that battle in 1989," short of allowing "the Gramm-Rudman automatic sequestration trigger to be pulled." He added that he did not believe Congress would allow this to happen, since they would not be willing "to pay the price of across-the-board cuts in non-entitlement programs."

"Federal spending remains the villain in the Federal deficit story."

There is danger even if the government reaches the point where sequestration or a waiver of sequestration is seriously considered, Archer asserted, cautioning, at that point, "the whole process will become driven by the politics of the situation . . . and any hope of bipartisanship will go out the window." Should this occur, he forecast "a return to the bitter confrontational atmosphere of 1987."

Archer called that a "giant step backward from the healthy spirit of bipartisanship which Dan Rostenkowski and I have tried—successfully—to nurture in the Ways and Means Committee this year," a step neither he nor Chairman Rostenkowski wanted to see taken.

"One of the most unfortunate legacies of tax reform is some implied understanding that provisions which were linked to one another . . . for the purpose of winning support for the overall package . . . somehow should remain linked for all time."

The Democratic majority is "likely" to send the President a bill containing revenue increases, Archer predicted, although he indicated that he foresaw no new form of taxation. He described the question as "not so much whether there will be such a bill, but whether the Administration—and Republicans in Congress—will have a hand in shaping one which the President might sign." He warned, "The stage is clearly set for such a bill in 1989," noting a number of factors pointing in that direction.

Archer urged that "the reality of the situation demands early bipartisan action"and called for a budget summit "during the first weeks of the new Administration."

He asked for "serious, substantive discussions about a multi-year program of deficit reduction."

Regarding prospects for tax increases during the coming year, Archer pointed out, "If we're going to be dealing with additional revenues as part of the agreement . . . and reality tells me that in spite of my own strong preferences the majority will likely insist on new revenues . . . we should do so on the basis of tax policy . . . not tax politics." He added that if the minority party does not become part of the process early on, the majority party will not take the time "to step back from the political rhetoric of recent campaigns . . . and look at the overall policy benefits of measures such as a capital gains tax differential and the indexation of the cost basis of capital gains." Other policy issues that may be overlooked include foreign source income provisions, simplicity, international competitiveness, private pension plans, the corporate minimum tax and passive loss rules.

"One of the most unfortunate legacies of tax reform is some implied understanding that provisions which were linked to one another . . . at that time . . . for the purpose of winning support for the overall package . . . somehow should remain linked for all time," Archer observed. Instead, he called on Congress to "reopen" major areas of the 1986 Tax Reform Act for policy review.

"I'm not suggesting that 1989 should be the year that the entire tax code is reviewed and rewritten again," he explained, adding "I do think, however, that it's time to being moving ahead with Tax Reform. . . . That's a process we can begin in 1989."

The Texas Congressman concluded his remarks with a call for cooperation toward that objective. "Right now is the time and place for statesmanship—not partisanship . . . policy—not politics . . . cooperation—not confrontation . . . answers—not excuses," he told the corporate executives and press attending the dinner.

Tax Features

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Budget Watch By Allen Schick

Reagan's Budget Legacy and Bush's Budget Quandary

George Bush will inherit a budget and an economy shaped by his predecessor's policies and actions. When he takes office in January, the new president will have to decide whether to continue on the path charted by Ronald Reagan during the past eight years. His predicament will not be an enviable one: doing nothing might trigger deep percentage cuts in national defense and in numerous social programs; raising taxes or selectively curtailing programs might be an unpopular beginning for a new President. If the recent election campaign is a guide, Bush will oppose tax increases, seek to restrict spending growth to the rate of inflation, avoid big shifts in fiscal policy, and hope for a gradual reduction in the budget deficit. But staying on course will depend on a cooperative economy as well as on a cooperative Congress. A number of things can quickly go awry and compel the new President to deviate from inherited policies or campaign pledges. Even if the early months of his presidency are quiet, Mr. Bush might come up against the deficit targets set by the Gramm-Rudman-Hollings process.

When he takes office in January, [Bush] will have to decide whether to continue on the path charted by Ronald Reagan . . . His predicament will not be an enviable one . . .

The Pesky Budget Deficit

Deficits have been standard operating procedure in Washington for some time. The last balanced budget occurred in 1969; only 10 of the past 60 budgets have paid their own way. But there is a startling difference in magnitude between Reagan's deficits and those incurred in earlier periods. Before Reagan, most deficits were quite small; Reagan's have been huge. In the 1970s, the biggest deficit was $74 billion; in the 1980s, the smallest has been $74 billion. Budget deficits averaged less than 1 percent of GNP in the 1960s, more than 2 percent in the 1970s, and almost 4 percent of GNP thus far in the 1980s. By the time the books are closed on the Reagan era, the cumulative deficit will have been almost one and a half trillion dollars and the national debt (which grows faster than the deficit) will have tripled from $900 billion at the start of the decade to more than $2.8 trillion.

The Economy: Is Growth Enough?

President Bush will not be able to count on the economy to solve his deficit problem. In the past, deficits abated when the economy expanded, as additional funds flowed into the treasury. One of the truly startling characteristics of recent deficits is that they have persisted during the longest peacetime expansion in American history. The United States has just completed six consecutive years of expansion, but the annual deficit is stuck above the $100 billion mark. The long expansion and the lowest unemployment rate since the early 1970s are justifiably among President Reagan's proudest achievements. Reagan's policies have been a major factor in this favorable economic performance. By avoiding the policy lurches which characterized the 1970s, Reagan has provided markets and entrepreneurs with clear and stable signals. But while growth has been protracted, it has not been as robust as in past cycles. Real output increased 38 percent during the 1970s and (with only one year to go in this decade) less than 25 percent in the 1980s. Thus, even if George Bush avoids an early recession, economic growth will have been significantly weaker than in previous decades. It might be difficult to squeeze additional growth out of the economy without risking a resurgence of inflation. Whatever its virtues, moderate growth assures continuing deficits under current revenue and spending policies. Even if they were sustained for an extended period of time, real gains of three percent or less a year will not supply a sufficient increment for the government to grow out of the budget deficit. CBO has projected a baseline deficit in excess of $120 billion for fiscal 1993—the year that the Gramm-Rudman-Hollings law promises a balanced budget. Two recent bits of news point to the intractability of the deficit under existing policy. One was the report that the fiscal 1988 deficit exceeded that for the previous year; the other was that OMB has added more than $20 billion to the estimated 1990 deficit.

President Bush will not be able to count on the economy to solve his deficit problem. . . . One of the truly startling characteristics of recent deficits is that they have persisted during . . . six consecutive years of expansion. . . stuck above the $100 billion mark.

These news items might be harbingers of still more unfavorable developments in the years ahead. Leaving aside the growing balances in the social security trust funds, the deficit in the general accounts is expected to worsen during George Bush's term as President. Without these balances, the fiscal 1993 baseline deficit would be $220 billion, some $100 billion higher than CBO has projected for the unified budget. If the social security balances are used to finance the deficit, the United States will continue to have inadequate savings and it will con-

(Continued on page 4)

(BUDGET WATCH, *from page 3*)
tinue to look abroad for large infusions of capital. Unfortunately, much of the borrowed money has gone to prop up consumption. Without increased saving and investment, the massive run-up in debt will have to be serviced by an economy whose long-term potential has been diminished by weak productivity gains. Not only will we have a bigger debt burden, but we will have a smaller (than possible) economic base from which to pay our obligations. If growth doesn't suffice, George Bush will have only two ways of dealing with the deficit: more taxes or less spending. The first option would break with Reagan's policies and with Bush's campaign pledges; the second would run afoul of pressure in Congress and elsewhere to maintain current or higher levels of expenditure.

Reagan's Tax Legacy: More Earmarked, Fewer General Taxes

George Bush will confront a markedly different tax situation than the one which Ronald Reagan faced eight years ago. Income taxation has been revolutionized by Ronald Reagan. The top tax rate on individual income has been reduced from as much as 70 percent to only 33 percent; the top corporate rate has been lowered from 46 percent to 34 percent; numerous preferences have been ended or narrowed; and individual tax rates have been indexed to changes in consumer prices. As a result of these and other policy changes, individual income taxes have dropped from 9.6 percent of GNP in 1981 to an estimated 8.2 percent in 1989. Had these taxes remained constant relative to GNP, Americans would now be paying $60 billion more in income taxes each year.

If the social security balances are used to finance the deficit, the United States will continue to have inadequate savings and it will continue to look abroad for large infusions of capital.

The decline in income taxes has been partly offset by a rise in social security taxes. Social insurance taxes have climbed from 6.1 percent of GNP in 1981 to an estimated 7.1 percent in 1989. These taxes now produce 36 percent of total federal revenue, up from 31 percent in Reagan's first year.

Total federal revenue has receded from the historically high level (20 percent of GNP) reached in 1981. But at 19.3 percent of GNP, it is still a full percentage point above the average for the 1970s. This comparison with past tax burdens is the basis of President Reagan's claim that the deficit is not due to undertaxation. But while it is true that total revenue remains above the long-term trend, the changing composition of the revenue has led to a situation where the government collects ample funds for earmarked purposes but is unable to cover the costs of programs which lack their own revenue source. General revenues, which pay for national defense, the ongoing operating costs of government agencies, and most discretionary domestic programs, are now a smaller percentage of GNP than at any time since World War II. General revenue is less than 12 percent of GNP; it was almost 15 percent of GNP in 1960 before any of the Great Society programs were established. The inadequacy of general revenue is the main cause of today's budget deficit. The trend toward earmarked revenue and away from general taxes might pick up steam during the Bush presidency. As a candidate, Bush indicated a strong preference for earmarked taxes, such as the additional medicare premium levied this year to pay for new catastrophic illness coverage. Apparently, Mr. Bush does not regard these earmarked payments as taxes; hence, they would not be precluded by his "read my lips" opposition to tax increases. There appears to be strong political support for the lower marginal tax rates enacted in 1986. These rates may be the most untouchable feature of the Federal tax structure. Politicians will have to look elsewhere it they want additional revenue. It also will be difficult to raise significant amounts of revenue by closing loopholes in the tax laws. Most of the corporate tax preferences have been eliminated; most of the individual tax preferences enjoy widespread political support. In the aftermath of last year's market crash, the President and Congress negotiated for more than a month before coming up with $27 billion of revenue enhancements (over a 2-year period). In calmer circumstances, even this relatively small amount of revenue might be beyond reach.

Reagan's Spending Priorities

Ronald Reagan has had his share of budget ups and downs. No previous president was so successful in quickly molding the budget to fit his policies. At the dawn of his presidency, Reagan skillfully pressured Congress to revamp national priorities by cutting domestic programs and building up defense resources. Barely half a year after he took office, Congress had enacted far-reaching cutbacks in federal spending and a steep drop in tax rates. Since 1981, however, Reagan and Congress have been locked in a protracted budgetary war, with neither side able to dislodge the other from its basic positions. The table on the next page indicates that Reagan has had modest success in altering budget priorities, but there are both similarities and differences in the last pre-Reagan budget and Reagan's final budget. Three categories—national defense, interest charges, and mandatory payments—account for about 85 percent of federal spending. All other programs compete for the remainder.

Apparently, Mr. Bush does not regard these earmarked payments as taxes; hence, they would not be precluded by his "read my lips" opposition to tax increases.

(Continued on page 5)

Budget Deficit

Address budget and deficit issues, Shadow Committee urges candidates. Tax Features Feb./Mar. 1988 p. 1.

Lessons from the budget summit, by Allen Schick. Tables. Tax Features Jan. 1988, p. 3.

Reagan's budget legacy and Bush's budget quandary, by Allen Schick. Table: Budget and GNP shares. Tax Features Nov./Dec., p. 3.

Shadow Budget Committee urges deficit reduction upon National Economic Commission. Tax Features July/Aug. 1988, p. 1.

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Shadow Committee urges new budgetary procedure during transition. Tax Features Oct. 1988, p. 1.

Corporations – Taxation

Corporate tax burdens, by Edward A. Sprague. Historical tables: receipts; profits; legislation; federal/state/local income and payroll taxes. Federal Tax Policy Memo Feb./Mar. 1988. 2 pages.

Corporations, Multinational

New study hits U.S. taxation of multinationals. Tax Features Feb./Mar. 1988, p. 2.

Defense Budget

The defense roller coaster, by Allen Schick. Historical table. Tax Features Apr./May 1988, p. 3.

Deposit Insurance, Federal

Time bomb for taxpayers: Federal credit losses, by John Hanly Adams. Federal Tax Policy Memo, Oct. 1988. 2 pages.

Expenditures, Federal

The disappearing impoundment power, by Allen Schick. Table: Rescissions and deferrals, 1975 - 1988. Tax Features Oct. 1988, p. 3.

Making elderly Americans dependent on government assistance, by Allen Schick. Table: Federal outlays. Tax Features Feb./Mar. 1988, p. 3.

Moderate income American family will pay total Federal taxes of $7,943 in fiscal 1988. Table: Federal expenditures by function and workers' share. Tax Features Apr./May 1988, p. 4.

Will there be a new boom in Federal spending? by Allen Schick. Tax Features Sept. 1988, p. 3.

Expenditures, Government

Government and your tax dollars: the spending side. Table: How Federal, state and local governments spend each dollar of public funds, 1960 - 1986. Tax Features July/Aug. 1988, p. 7.

Grants-in-aid

Federal grants drop 4.5%; FL, TX pay highest aid premiums. Table: Grants and tax burden for grants by state, FY 1987. Tax Features June 1988, p. 2.

Income

Typical two-earner family increased purchasing power since 1980. Table: Median income before and after direct Federal taxes and inflation, 1980 - 1988. Tax Features June 1988, p. 1.

Property Taxes

1986 property tax growth outpaces other taxes. Table: Collections by state, per capita and per $1,000 personal income, FY 1976 and 1986. Tax Features Feb./Mar. 1988, p. 1.

Revenue

Government and your tax dollars: the revenue side. Table: How Federal, state, and local governments raise each dollar of public funds, 1960 - 1986. Tax Features July/Aug. 1988, p. 3.

Revenue, Federal

The deficit that won't go away, by Allen Schick. Historical tables: General fund and trust fund balances, and total deficit and debt; general fund receipts. Tax Features July/Aug. 1988, p. 3.

Hidden taxes and user fees: the plague spreads, by John Hanly Adams. Federal Tax Policy Memo Sept. 1988. 2 pages.

Revenue Act of 1987

Tax package adopted; process sags again, by Edward A. Sprague. Table: Vanished corporate tax cut of 1981. Federal Tax Policy Memo Jan. 1988. 2 pages.

Social Security

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The future of social security financing, by Edward A. Sprague. Tables: OASDI and HI ncome and outgo by alternative assumptions 1988 - 2060; Age structure of transfers under OASDI. Federal Tax Policy Memo June 1988. 8 pages.

Social Welfare

Social welfare outlays dominate government expenditures. Table: Federal, state and local expenditures by source of funds and type, FY 1960 - 1985. Tax Features Sept. 1988, p. 5.

Tax Burden, Federal

FY '88 tax burden up $55 billion; increase falls on corporations. Table: Tax burden by state. Tax Features Feb./Mar. 1988, p. 2.

Top 50 percent of earners pay 93.8 percent of Federal individual in-

(Continued on back)

come tax burden; top ten percent pays over half. Graphic. Table: High and low income taxpayers: 1979 and 1986. Tax Features June 1988, p. 1.

Tax Burden - U.S.

Tax Freedom Day 1988 is May 5; two days later than 1987. Graphics. Tax Features Apr./May 1988, p. 1.

Tax index reaches record level as 1st quarter 1988 taxes rise $110.9 billion. Table: Total, Federal, state and local indices 1970 - 1988. Tax Features Oct. 1988, p. 2.

Workers lose two more minutes of a day's pay to tax bite. Historical table, graphic. Tax Features Apr./May 1988, p. 1.

Tax Evasion

Persistent tax gap due mostly to individual underreporting. Table: Income tax gap by source, tax year 1987. Tax Features July/Aug. 1988, p. 1.

Tax Expenditures

Tax expenditures: myths and realities, by Allen Schick. Tables. Tax Features June 1988, p. 3.

Tax Legislation

U.S. endures two decades of accelerating tax legislation; wobbling in Federal policy. Table: revenue impact on corporations and individuals, total as percent of GNP, 1964 - 1990. Tax Features Jan. 1988, p. 1.

Taxation - OECD Countries

Tax structures vary greatly within OECD. Table: Percentage distribution of revenues in selected countries by source, FY 1986. Tax Features Oct. 1988, p. 5.

Taxation, Federal

"Soak the Rich" by taxing the highest earners 100 percent . . . and run the Federal government for 12 days! Table. Tax Features Sept. 1988, p. 1.

Taxation, State

State tax and fiscal prospects, 1988, by Elsie M. Watters. Special Report Apr./May 1988. 4 pages.

Sales taxes rake in revenue for the states. Tables: revenues by type of tax state tax rates. Tax Features Apr./May 1988, p. 6.

(BUDGET WATCH, *from page 4)*

National defense. Defense has been the most cyclical part of the budget. After rising sharply in the first half of the 1980s, the new resources provided the Pentagon have levelled off in the second half. This pattern closely conforms to shifts in public opinion. Most Americans favored the defense buildup at the start of the decade; most now think that defense spending should remain the same or be decreased. Although the Defense Department has $250 billion in carry-over funds which have facilitated its adjustment to more austere circumstances, it will not be able to acquire all the weapons scheduled in its 5-year plan. Nor will it be able to man and operate all the forces it already possesses unless the defense budget is permitted to grow in real terms. The 1989 Reagan budget was a harbinger of what might be in store for a Bush Administration. Despite his strong support for defense, Reagan proposed the deactivation of air wings, early retirement of ships, and other force reductions. For the most part, however, the last Reagan budget relied on deferments and stretch-outs to avoid a basic review of mission and force levels. It is doubtful that these expediencies will suffice if the defense budget is held to zero real growth.

Mandatory entitlements. Most of these are payments to the retired, poor, disabled, unemployed, or other persons entitled to financial assistance. These payments are mandated by law; in most cases, cost of living increases are also mandated.

Ronald Reagan has had little success in curbing the growth of these payments. They have the same share of GNP today as in 1980, and they now account for almost half of total outlays. There appears to be widespread political support for protecting means-tested entitlements (for low-income persons) against cutback and political opposition to cutting middle income transfers. Social security benefits are treated as untouchable by Democratic and Republican politicians alike. Medicare has been nicked, but its costs race ahead of GNP and over-

(Continued on page 6)

THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

"Mandated Benefits"

Official Washington is cagey. Bar one road to increasing spending, and the White House and the Congress will quickly find another. The child of the 80s, when it comes to backdoor spending, is Mandated Benefits.

Under this rubric, Uncle Sam determines a benefit the citizens are deemed to need. The private sector is then required to provide and pay for this worthy service.

Caught between the rock of Gramm-Rudman deficit targets and the hard place of demands for new programs or increased benefit levels in existing ones, Congress made its first major move in this direction under COBRA, the Consolidated Omnibus Budget Reconciliation Act of 1985, which mandated continuing health care for employees who were laid off and their families. The 101st Congress, under the same pressures, will probably try to mandate benefits for long-term health insurance and parental leave, among others.

What's so bad about that? Improving and expanding benefits is in many cases a worthy goal. But letting Uncle Sam decide what those benefits shall be, who shall furnish them, and at what level, may not be the most desirable way of addressing the social agenda.

First off, what has happened to the due process clause of the U.S. Constitution? Does government have the right to preempt millions of dollars of corporate revenues and specify how these shall be spent without giving corporate officers or shareholders any say?

Next, while we have yet to assess the impact of mandating benefits on the collective bargaining process, it is only logical to reason that the more items that are mandated, the fewer things that are on the table come contract time.

An additional consideration is that when government mandates benefits, finessing the cost onto U.S. businesses, the pain of paying for the program is detached from the pleasure of receiving the benefit. This is always bad policy. The net drag on the economy, however real, may be imperceptible, but the death of a thousand cuts is just as lethal as beheading — it only takes longer.

Finally, as someone said in a different context, "The generals are always preparing to fight the last war." Big government is usually behind the curve, often out of touch with reality. A number of years ago, a Federal agency prescribed how New York City's buses ought to be built to reduce polution and increase safety. The only problem was that the buses kept breaking down, and New York City had to acquire older buses from Washington, D.C., to keep its surface transportation system running.

Do we really want the White House and Congress telling all Americans exactly what benefits they need, at what level, for what cost, and then embedding these programs in the corporate benefit system? I suspect not. I suspect that doing so would simply give us a bus that looked good on paper, but that ended up either taking us to the wrong destination or nowhere at all.

Base Closing Commission

The President has signed a law empowering a Carlucci-chosen commission to produce a list of bases suitable for closing. The commission's schedule:

12/31/88 Commission report submitted to defense secretary.

1/16/89 Defense secretary submits list to Congress, if he chooses.

3/1/89 Start of 45-day window during which Congress can veto the base closing list – only by majority of both houses.

1/1/90 Earliest date first base can be closed.

(BUDGET WATCH, *from page 5*)

all budget trends.

George Bush can expect enormous pressure in this sector of the budget. There are strong demands for federal assistance in financing nursing and home care for the elderly. As the number of elderly Americans rises, so too does their draw on the federal budget.

Net interest. This is the truly uncontrollable portion of the budget, for it represents outstanding commitments to bondholders. Interest payments have soared along with the accumulation of public debt. In 1980, less than 9 percent of outlays were diverted to interest charges; today more than 14 percent is paid out in interest. With the buildup in debt, the budget has become increasingly sensitive to fluctuations in interest rates. The recent uptrend in these rates has added billions of dollars to the fiscal 1989 deficit.

Nondefense discretionary spending. This "all other" category covers hundreds of federal programs, the operating costs of federal agencies, and many grants to state and local governments. This is the area in which the Reagan budget revolution has been most successful. Discretionary domestic spending has been crowded out by other demands on the budget, and its share of national output and of total outlays is substantially less than at the start of the decade.

Much as he may want to do so, George Bush will not have much opportunity to sharpen his budget knife here. The big cuts have already been made. While additional savings may be justified, it will be hard to marshal support for them. In fact, Candidate Bush identified a number of problem areas—education, drug control, day care and environmental protection, for example—where additional resources might be allocated.

Budget and GNP Shares
(In percent)

	Budget Shares*			GNP Shares*		
	1980	1985	1989 est.	1980	1985	1989 est.
National defense	22.7	26.7	26.6	5.0	6.4	5.9
Mandatory entitlements	47.0	46.3	47.5	10.4	11.1	10.5
Net interest	8.9	13.6	14.5	2.0	3.3	3.2
Discretionary domestic	26.6	18.6	16.9	5.9	4.5	3.7
Total outlays	—	—	—	22.1	24.0	22.1

Source: Congressional Budget Office
*Because offsetting receipts are excluded, the budget and GNP shares add up to more than 100 percent.

The Budget Honeymoon

George Bush will face tough choices almost immediately after taking office. By then, the 2-year budget agreement will be drawing to a close and the gap between the fiscal 1990 GRH deficit target and budget realities will become more evident. Ronald Reagan's departing budget—to be issued about 10 days before inauguration—will undoubtedly paper over the gap by proposing severe cuts in both discretionary and mandatory programs. One of Bush's early decisions will be whether he should stick with Reagan's budget or develop his own proposals. His predicament will not be an enviable one: doing nothing might trigger deep percentage cuts in national defense and in numerous social programs; raising taxes or selectively curtailing programs might be an unpopular beginning for a new President. Congress will have a big say in budget policy. The overwhelming odds are that 1989 will not be a replay of 1981, that Bush will have difficulty imposing severe domestic cutbacks on a Democratic Congress that gained strength in the recent election. Bush can decide to confront Congress on budget policies and priorities, refusing to give ground until the government is at the brink of stalemate. Or he can seek a less confrontational honeymoon, seeking a negotiated agreement with Congress. The most relevant precedent for Bush might be what Reagan did near the end of his presidency, not what happened at the start.

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TAX·FEATURES

Election Year Politics and Fallout From TRA'86 Dominate 1988 Federal Tax Scene

Fiscal Condition of Most State And Local Governments Improves

Many states improved financially in 1988, primarily due to a strong national economy and various tax increases enacted in 1987. However, a few large states suffered severe deficits. California, Connecticut, Massachusetts, and New York contended with revenue shortfalls ranging from $250 million to over $1 billion during 1988.

State and local governments collected $421.8 billion in taxes during the 12 months ending March 1988, an increase of 8 percent, or $31.2 billion, over the previous year. State tax collections totaled $259.7 billion, up 8.3 percent, and local government taxes netted $162.1 billion, showing a 7.5 percent rise. Thirty-four states raised taxes, mostly on sales taxes covering motor fuel, tobacco, alcoholic beverages, and general sales.

High Court Decisions

State and local governments suffered a setback in their borrowing efforts under *South Carolina v. Treasury Secretary*. The court ruled that the provision in the Tax Equity and Fiscal Responsibility Act of 1982 which denies Federal income tax exemption for interest earned on long-term publicly offered state and local bonds not issued in registered form violates neither the Tenth Amendment and principles of Federalism nor the doctrine of intergovernmental tax immunity. The bond registration requirement was intended to prevent Federal tax evasion and money laundering schemes. It has proved successful since no state or local government has since issued any bonds in other than registered form.

In a controversial case with potentially wide-ranging consequences, *D.H. Holmes Co. v. Louisiana Secretary of Revenue and Taxation*, the court unanimously ruled that Louisiana's use tax on merchandise catalogs ordered from out-of-state by a Louisiana retailer and shipped to prospective customers within the state does not violate the Commerce Clause of the Constitution.

Despite $909.0 billion in revenues in FY'88, a 6.4 percent increase over 1987 collections, the Federal government left itself with a budget deficit of $155.1 billion, exceeding the 1987 deficit by $5.4 billion. Due to the stubborn budget deficit that represents over 3.3 percent of total Gross National Product (GNP), pressure continues to mount to raise taxes or cut government spending in order to reduce the red ink in Federal government accounts. It may seem surprising that 1988 saw no major legislation to combat the problem, but there are several reasons why this issue has been side-stepped.

First, since 1988 was an election year, major tax-raising legislation was politically untimely. The budget "summit" between the Administration and Congress, convened in the wake of the 500-point drop in the stock market on October 19, 1987, conveniently worked out a two-year deficit reduction plan to avoid election-year tax manipulation. The budget summit culminated in the Revenue Act of 1987 which called for $8 billion and $14 billion in new tax revenues for FY'88 and FY'89, respectively.

Secondly, the public is still absorbing the impact of the Tax Reform Act of 1986 (TRA'86) which radically changed the Tax Code for individuals and corporations. Since many of TRA'86's provisions are staggered over five years, its full effects will not be felt until 1990 or later. Another major tax act in 1988, attempting to address the budget deficit, could not have gained enough political momentum, especially if it involved increasing the income tax rates established in 1986.

Faltering NEC

Thirdly, no major deficit reduction legislation was witnessed in 1988 because of the appointment of the National Economic Commission (NEC) late in 1987 to address the deficit problem. The 14-member, bipartisan panel, comprised of business, labor, and Congressional leaders appointed by the President and Congress, is scheduled to report its deficit reduction recommendations in March of 1989. But many budget observers predict its report will be kept on ice pending the course of direct deficit reduction discussion between the Bush White House and the Congress. Substantive tax increase options are unlikely in the wake of President George Bush's "read-my-lips" pledge not to raise taxes and subsequent declaration that he would

(Continued on page 2)

THIS ISSUE:

PAGE 1:
Tax Action '88: Federal, State & Local
PAGE 3:
"Budget Watch"
PAGE 5:
"Front Burner"
International Tax Action '88
INSERT:
Avoiding Budget Limitations

(FEDERAL TAXES, *from page 1*)

not support any tax increases proposed by the Commission.

Catastrophic Care

On July 1, 1988, the Medicare Catastrophic Coverage Act of 1988 was signed into law. The act was designed to shield elderly Americans from the financial burden of acute illness, and will significantly expand the Medicare program by limiting the amount that Medicare's 33 million beneficiaries must pay for hospitalization and doctors' services.

The benefits contained in the Medicare Catastrophic Coverage Act of 1988, estimated to cost about $31 billion between 1988 and 1993, are paid for primarily by the people who are expected to be beneficiaries of the program. Payment is made in the form of (1) increased income taxation of Medicare-eligible individuals called the "supplemental premium" and (2) increased part B monthly premium rates (also called the "flat" premium). The supplemental premium is intended to provide approximately 63 percent of the catastrophic and drug benefit financing, while the flat premium is expected to finance the remaining 37 percent of the program.

Many tax analysts consider the new supplemental premium a poorly disguised progressive tax increase since the act will boost the amount the nation's higher-income senior citizens owe the Internal Revenue Service by as much as $1,600 per couple in 1989 and up to $2,100 in 1993. Poorer seniors will pay as little as $96 a year per couple. Higher-income Medicare beneficiaries are required to pay a 15 percent surcharge on their Federal tax in 1989, rising to 28 percent in 1993. The surcharge will be imposed only on recipients with incomes high enough to require the payment of Federal taxes of more than $150 — representing about half of all couples. In the final analysis, the Catastrophic Coverage Act will require senior citizens to pay an additional $19 billion to the IRS over the next five years.

Technical Corrections

The only general tax legislation passed in 1988 was the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) signed by President Reagan on November 11, 1988. TAMRA put an end to the two-year long battle involving technical corrections to TRA'86 and other recent tax laws, as well as extending sought-after expiring tax breaks. Some of the major extensions and modifications include:

- Extension of tax exclusion for employer-provided educational assistance for 1988.
- Modification to expand the low-income rental housing tax credit.
- Extension of the states' authority to issue qualified tax-exempt mortgage bonds.
- Extension of the 20 percent research tax credit allowed for qualified research expenditures incurred in carrying on trade or business.
- Extension of the business energy tax credits for solar, geothermal, and ocean thermal property.
- Extension of the targeted jobs tax credit.
- Modification of mutual fund shareholder expenses to exempt them from taxation.

The Losers

TAMRA will pay for the extended tax breaks by raising more than $4.1 billion over three years, primarily by accelerating payments of corporations' estimated taxes, curbing limited premium life insurance policies that were seen as tax shelters, and restricting loss transfers by Alaskan native corporations. TAMRA also put into place a temporary 15 percent excise tax on a company's withdrawals of pension surpluses to discourage the use of such assets by the company or another company that seeks to acquire it.

Defense Takes a Hit

TAMRA targeted defense contractors recently under attack for defense procurement scandals, extracting from them $1.3 billion over a three-year period — almost one-third of the act's $4.1 billion revenue increase. Defense companies and other long-term contractors unsuccessfully fought the provision restricting the popular tax-deferral accounting technique known as the completed contract method of accounting. This method allows contractors to delay paying part of their taxes on income received from a contract until the contract has been completed. TAMRA now allows only a 10 percent tax deferral as opposed to the 30 percent income tax deferral previously allowed. Single-family homebuilders are exempt from this new provision and can continue to use the completed contract method of accounting to defer taxes. TAMRA will also raise revenues by establishing a 45-cent-a-pound excise tax on pipe tobacco. Persons who use their home as an office will get less of a tax break, and deducting the base cost of a telephone that is also used for personal purposes will no longer be allowed.

Another important provision included in TAMRA was the removal of the limit on the amount of long-term bonds that the Treasury can issue. This provision was sought by the Administration in order to finance the national debt which reached over $2.6 trillion by the end of FY'88 — representing over $10,600 for every man, woman, and child in the United States.

Taxpayer Bill of Rights

TAMRA established the first Taxpayer Bill of Rights, which gives taxpayers specific rights in dealing with the IRS, provides procedures for taxpayers regarding the IRS, adds levy and lien provisions, and extends the tax court's jurisdiction. The Taxpayer Bill of Rights allows a taxpayer to be represented by a CPA, attorney, or other person authorized to appear

(Continued on page 6)

Tax Features

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Budget Watch By Allen Schick

Government Sponsored Enterprises

The Next Crisis in Federal Budgeting?

No sooner does the Federal government move to control one budget loophole that another one, wider than the first, pops open. If any new proof is needed of this perennial budget problem, it is amply provided by the recent popularity of GSEs, one of the most obscure and least understood areas of Federal budgeting. GSEs—shorthand for government sponsored enterprises—operate in the twilight zone between the public and private sectors. The GSEs are private institutions established by the Federal government to channel credit to certain sectors of the economy. Their hybrid status enables the GSEs to escape both the discipline of the market and the effective control of government.

The Ambiguous Status of GSEs

Government sponsored enterprises are private corporations chartered by the United States Government to perform certain "public" functions. Most of them are financial intermediaries; they provide credit to (or purchase the financial assets of) banks and other institutions which in turn make loans to farmers, homeowners, and students. There now are ten such enterprises, twice as many as there were in 1986. Some of the enterprises are well-known; others (especially those recently established) operate in obscurity. Half of the enterprises have acquired humanoid names: Fannie Mae (Federal National Mortgage Corporation), Sallie Mae (Student Loan Marketing Association), Freddie Mac (Federal Home Loan Mortgage Corporation), Farmer Mac (Federal Agriculture Mortgage Corporation), and Connie Lee (College Construction Loan Insurance Association).

The GSEs borrow and lend truly prodigious amounts of money each year. They handle about $400 billion a year, have loan portfolios that exceed those of the largest American banks, and provide much more credit than the combined total of all Federal agencies. Direct lending by Federal agencies (which is included in the budget) has dropped in recent years, reversing several decades of steady growth. This development may be due to installation of a credit budget system which limits the volume of loans that can be made or guaranteed by Federal agencies. But as government credit has been somewhat controlled, the GSEs have more than picked up the slack. In 1988, the government issued $27.2 billion in loans, sharply down from the $52.8 billion issued only three years earlier. It also guaranteed $100.7 billion in private loans. But the GSEs made $378.1 billion in loans, almost double the amount issued only four years earlier.

Table 1 plots the explosive growth of GSE credit activity during the 1980s. At the end of the decade, the government sponsored enterprises are making more than four times as many loans as they were making at the start of the decade. As a consequence, there has been an astounding buildup in the volume of GSE loans outstanding, from only $182 billion in the 1981 fiscal year to an estimated $719 billion in fiscal 1989. Since these enterprises do not generate their own resources through business activity, they must borrow money in order to be able to lend it out. Consequently, there has been a steady rise in GSE debt, the amount owed to others. This debt now stands at approximately three quarters of a trillion dollars.

GSE credit activity far outstrips that of the Federal government itself. As recently as 1981, however, the government was issuing and guaranteeing more loans directly than through the enterprises. In 1981, GSEs had a smaller volume of direct loans outstanding than the government. Today, however, the GSE loan portfolio is three times larger than the Federal government's. Similarly, in 1981, GSEs' outstanding loans totaled only about half the size of federally-guaranteed loans; today, they are almost one and a quarter times the size.

The GSEs have become a dominant force in U.S. credit markets, especially in agriculture and housing—two credit-hungry sectors of the economy. In 1987, these enterprises accounted for one out of every six dollars advanced or borrowed in the credit markets. This penetration, as Table 2 shows, is almost three times greater than it was in 1983.

Because they are deemed to be private, the transactions of these enterprises are excluded from the Federal budget. However, financial statements and other material pertaining to the

(Continued on page 4)

Table 1

Lending And Borrowing by Government Sponsored Enterprises

(dollars in billions)

	Fiscal Years								
	1981	1982	1983	1984	1985	1986	1987	1988	1989est
GSE Loans	$ 119.2	$ 151.7	$ 169.4	$ 200.6	$ 260.0	$ 391.0	$ 427.5	$ 378.1	$ 391.1
GSE Loans Outstanding	$ 182.3	$ 225.6	$ 261.2	$ 314.1	$ 369.9	$ 453.3	$ 581.1	$ 666.1	$ 719.5
GSE Loans Outstanding as % of Outstanding:									
Direct Loans	98.5%	108.6%	117.1%	137.0%	143.7%	180.2%	248.1%	300.0%	343.8%
Guaranteed Loans	59.0%	68.1%	71.8%	81.2%	90.2%	100.8%	114.6%	121.1%	122.7%
GSE Debt	$ 161.8	$ 205.5	$ 239.9	$ 294.8	$ 351.6	$ 458.1	$ 569.2	$ 663.2	$ 734.0

Source: U.S. Office of Management and Budget, *Special Analysis* and *Historical Tables*.

(BUDGET WATCH, *from page 3*)

GSEs are annexed to the budget Appendix. The private ownership test appears to provide an objective basis for excluding the enterprises from the budget. But it is not an adequate measure of the Federal government's involvement—financial and otherwise—in the GSEs. Table 3 indicates that all of the enterprises receive substantial benefits from the government not generally available to truly private corporations. Most of the enterprises have a line of credit at the Treasury, have their debt treated as equivalent to Treasury debt by banks, are exempted from SEC registration, and enjoy other valuable privileges. According to the Office of Management and Budget, "due to their perceived 'special relationship' with the Federal government, GSEs historically have been able to borrow in the credit markets at yields carrying only slight premiums above those of Treasury securities of comparable maturity." *The New York Times* (and other newspapers) list the debt of these enterprises as "Government Agency Bonds."

The GSEs are children of crisis. The oldest ones were established during the Depression when the credit markets were closed to most farmers and homeowners. For many years, the Farm Credit System (FCS), set up in 1933, took pride in its private status and boasted that it had not cost the government any money. But when farm income and the value of farm land plummeted in the mid 1980s, FCS was threatened with insolvency. Congress came to the rescue and established three new GSEs, each of which is ostensibly private but benefits greatly from Federal assistance. One of them—the Farm Credit System Financial Assistance Mortgage Corporation—has a $1.5 billion line of credit at the Treasury.

The Federal Home Loan Bank System is another GSE with its hands in Uncle Sam's deep pockets. It oversees the Federal Savings and Loan Insurance Corporation (which, is a government agency included in the budget). In 1988 alone, the Home Loan Bank System wrote more than $30 billion in IOUs, notes and other obligations to finance the liquidation or sale of insolvent savings banks. The status of these obligations (which, according to some estimates, might exceed $100 billion before the savings and loan mess is cleaned up) is uncertain, but one should not be surprised if the government ends up paying a big part of the bill. To help finance the savings and loan crisis, Congress established the Financing Corporation in 1987 and gave this new GSE authority to borrow more than $10 billion.

The law establishing the Financing Corporation states that its bonds are not direct obligations of the United States. But things are not as straightforward as they seem. Default by major GSEs is unthinkable and would probably do more damage to housing and agriculture than would abolition of the Agriculture and Housing and Urban Development Departments.

What should be done to rein in the GSEs before they grow so large as to impose great risks on the financial system? A 1985 study by the Congressional Budget Office identified four options: (1) Increased regulation to limit the risks taken by the GSEs; (2) privatization which would end the special relationship between the enterprises and the government; (3) public ownership which would give the government full control; and (4) imposition of fees on GSEs to reimburse the government for the benefits it provides them and the risks it bears.

Doing nothing is not a viable option. If the government addresses the GSE problem only at the point of crisis, as it has in agriculture and the savings and loan industry, it will have no choice but to make good on the bad debts of others. A good starting point would be to reexamine the status of the GSEs and decide whether they should be subject to the marketplace or to government control. It is no longer responsible to permit them to remain free of both.

Table 2
GSE Participation in U.S. Credit Markets
Selected years

	1973	1978	1983	1987
GSE Loans as % of Total Funds Advanced in U.S. Credit Markets	4.3$	6.6$	6.8%	16.8%
GSE borrowing as % of Funds Borrowed in U.S. Credit Markets	5.3%	5.6%	5.6%	15.9%

Source: U.S. Bureau of the Budget, Special Analysis.

Table 3
Status of Government Sponsored Enterprises

	When Established	Treasury Line of Credit	Exemption from SEC Registration	Treated by Banks as Treasury Debt
Federal Home Loan Banks	1932	Yes	Yes	Yes
Farm Credit System	1933	Yes	Yes	Yes
Federal National Mortgage Association	1938	Yes	Yes	Yes
Federal Home Loan Mortgage Corporation	1970	Yes	Yes	Yes
Student Loan Marketing Association	1972	Yes	Yes	Yes
College Construction Loan Insurance Association	1987	No	Unknown	Unknown
Financing Corporation	1987	No	Yes	Yes
Federal Agriculture Mortgage Corporation	1988	Yes	No	Yes
Farm Credit System Insurance Corporation	1988	No	Unknown	Unknown
Farm Credit System Financial Assistance Corporation	1988	Yes	Yes	Yes

Source: Office of Management and Budget, Budget of the United States Government, Special Analysis F.

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JANUARY/FEBRUARY 1989

Getting Around the Budget Limitations

Dedicated Financing and Credit Shenanigans

by Rudolph G. Penner
Senior Fellow
Urban Institute

Summary

Rudolph Penner is a Senior Fellow at the Urban Institute and former Director of the Congressional Budget Office. He is a member of the Tax Foundation-sponsored Shadow Committee on the Federal Budget.

In this article Mr. Penner describes why off-budget activity is likely to rise to new heights during the 101st Congress. He sees little hope of avoiding a prolonged impasse between the Bush Administration and Congress on deficit reduction. At the same time there are mounting pressures for more government spending. Penner foresees three strengthening trends as a result: (1) more off-budget Federal action, especially in credit programs and regulatory programs; (2) dedicated, deficit-neutral financing for what new initiatives the Federal government does implement; and (3) transference of more social activism and regulatory zeal to the state/local level. According to Penner, the costs imposed on business by these off-budget activities, including mandated benefits and state regulations, are likely to far exceed the costs imposed on business by any explicit Federal tax increases.

In the credit area, Penner sees more use of government guarantees and financing by government sponsored organizations to avoid the Gramm-Rudman-Hollings deficit limitations. These arrangements still can involve high costs for the Treasury. There are ways to bring the government guarantee process under better control, but government sponsored organizations are a "real growth industry." Bailing out the bankrupt thrifts will undoubtedly resort to an off-budget agency whose borrowings could cost 75 basis points or more above that for regular government bonds. Ultimately it will cost the taxpayers "a heck of a lot of money."

Mr. Penner's remarks were taken from an address to the Tax Foundation's 40th Annual Conference in New York City on November 30, 1988.

I find it hard to look forward to the next budget year with any great enthusiasm. I think that we are likely to see an impasse over the budget about as profound as any that we saw during the Reagan presidency. There is a fairly pronounced demand, at least as evidenced by the public opinion polls, for increased government activism on the one hand and on the other a great reluctance to pay higher taxes. And, of course, the Presidential campaign pandered to these discordant beliefs.

President-Elect Bush's one major fiscal promise is this so-called flexible freeze. I think the easiest way to think about it is to take social security, about 20 percent of spending, out of the picture; take interest, which is about 14 percent of spending, and set it aside; take defense, another 27 percent of spending or so which Mr. Bush wants to hold constant in real terms, and set it aside too. Then the notion of a flexible freeze is that you keep the rest of the budget constant in real terms, the word flexible meaning you can cut some programs and raise others.

If I were to point to the single most important reason that this is not a viable option, it would be the health care programs. The problem is that if we do nothing, if we don't change the health care laws at all, they will grow in

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real terms by somewhere from 8 to 10 percent per year. And they quantitatively dominate the budget portion that Bush would like to freeze.

Also in that portion are other large programs that are growing fairly rapidly in real terms such as military and civilian retirement. You also have programs like unemployment insurance that tend to grow faster than the rate of inflation.

So what a flexible freeze means is that you either have to radically restructure the programs that are growing rapidly — and there is really no political desire to do that in the Congress — or you just have to cut the smithereens out of the rest of the budget. There is no political will to do that in the Congress either. So if the flexible freeze is not viable and if tax increases are not viable as far as George Bush is concerned, you have the making of this profound impasse.

So what is likely to happen as a result of this impasse? You have, on the one hand a growing demand for more government spending. On the other hand, you have this huge deficit. It seems to me that you are going to see three important trends resulting from this situation.

The first are non-budget or off-budget forms of governmental activism. If you can't do it on budget, then hide it somewhere. And the two major categories of off-budget activity are credit programs and regulatory programs. I will focus more on the credit programs shortly.

A second trend is a much better one, and that is to the extent there are on-budget initiatives, under today's conditions the legislators feel the need to identify resources for them. That is to say new initiatives have to be deficit-neutral, both according to the procedure rules under Gramm-Rudman and more importantly simply because of the political mood, the political constraints on them. So you will see, I think, more things like the catastrophic health insurance plan where you had a tax increase and a premium clearly identified for that purpose. Or if you see a child care plan, you will probably see, as in some of the bills before the Congress, a reduction in the subsidy for child care now contained in the tax system. I don't necessarily mean earmarking, but I do mean an identified financing source.

I think this disciplines the system. It makes it very evident what the costs of programs are. And, indeed, the catastrophic health bill came pretty close to being defeated, in terms of how the political dynamics went once those enormous costs were so clearly identified. So it is disciplining. On the other hand, it's likely to result in a much more complicated tax system when you have special taxes or user fees for this and that. And you are in trouble of you ever make the mistake of identifying a revenue source that brings in too much revenue because you feel obligated to spend it on the earmarked program.

The third trend I see emanating is that to the extent people approach the Federal government for more social activism and are essentially turned away because the Federal government can't afford it, you will see more and more activity shift to the state and local level. The same public opinion polls that seem to demand more spending indicate that people trust state and local government more to spend their tax monies wisely than they trust the Federal government. I think basically it's a very healthy trend. It's actually been going on since the trough of the 1982 recession, but it does mean a very complicated situation for investors because in essence you have to keep track of the tax policies and the regulatory policies for 50 states as well as for the Federal government.

Business Costs

It would be my projection that over the next four years of President Bush's first term that the costs imposed on business by off-budget activities, plus the costs imposed through state and local tax increases and regulatory activities, are likely to far exceed costs imposed on business by explicit Federal tax increases (although there will probably be a few of those of a minor sort). That is why it's so important, I think, to look at these off-budget activities, and, in my view, to try and constrain them as much as possible.

The kind of devices you find off-budget are the sort that make it very hard to enforce any spending limits as implied, say, by Gramm-Rudman-Hollings or would be implied by a balanced budget constitutional amendment. Indeed, we have learned a lot from the state and local sector about how to evade constitutional limits of that sort. They give us lessons every year in new ingenious approaches to that problem.

I'm going to concentrate now on the credit programs. Credit programs are appropriate in certain circumstances. The problem is that the way we keep the accounts of the Federal budget greatly distorts our choice between one credit program as opposed to another. I identify three kinds of credit programs.

(1) There are direct loans usually made at favorable interest rates or subsidized interest rates.

(2) There are guarantees where the Federal government guarantees either 100 percent of a loan against default or some portion such as 90 percent. As an aside here, a lot of people misunderstand what it means when the Federal government guarantees 90 percent of a loan. Often they believe that if any loss is suffered the Feds

pick up 90 cents on the dollar and the private lender 10 cents. That's not usually how it works. It very often works that the Federal government picks up 100 percent of the first 90 percent of the loan value, so that it's very unlikely that the private lender will ever see any defaults. The programs vary, but that's a very typical kind of arrangement.

(3) The third kind of credit program involves government sponsored corporations. I'm thinking here of things like Fannie Mae, Freddie Mac, and now the brand new one, Farmer Mac. [see also Budget Watch, p. 3 of *Tax Features*]

Our budgeting techniques are probably somewhat biased against the first type, direct loan programs, because we keep the Federal budget on this peculiar cash basis and it is to the cash deficit that limits like Gramm-Rudman-Hollings apply. In other words, the first year you make a direct loan to someone, the subsidy value of that loan, essentially 100 percent of the loan, appears in the budget. So the subsidy value or the benefit to the borrowers is greatly overstated. When the loan is repaid, you get the reverse situation. One hundred percent of the repayment shows up in our cash budget.

One of the many ways that the Gramm-Rudman-Hollings deficit targets have been evaded, especially in 1987, was to allow for the early prepayment of loans made in the past. So for example, you have the rural electric cooperatives who had borrowed in the early 1980s from the Federal government at subsidized rate is higher than today's market rate. So like a lot of homeowners they wanted to refinance those loans. Well, it was very convenient for the Federal government to waive prepayment penalties, to take those loans in to meet the Gramm-Rudman-Hollings cash deficit targets.

But it cost the Treasury a lot of money to go through that artificial exercise. We lost the prepayment penalty. We lost the high interest on the loans that we had. Nevertheless, we sort of made the Gramm-Rudman target.

Federal Guarantees

Guarantees are favored by the budget accounting because they have no budget implications whatsoever unless the loan actually goes into default. And most politicians hope that will be after the next election! So there is a bias in budgeting toward the guarantees.

Now I think that CBO and OMB have suggested a rather neat approach to this problem that would improve the Federal budgeting for both direct loans and guarantees and eliminate some of these biases. With regard to subsidized direct loans, CBO and OMB suggest selling them back to the marketplace as soon as you make them. In other words, as a government agency you would make a subsidized loan, you would sell it to the market, and as the market would discount it, the value of the discount would be an excellent measure — if the market was working right — of the subsidy value of that loan, something that's not easy to estimate analytically. You would be substituting the market's view of the credit worthiness of the borrower for the agency's own. You would insist then that whatever agency was issuing this direct loan would go and get an appropriation from Congress to cover the discount. That would be the discipline. And I think it would work a lot better.

Now the critics of this approach say that there is an imperfect market out there for a lot of these loans. The marketplace might not bid their real value. So it is better to do it administratively. Have some bureaucrats estimate what the discount would be if there were a perfect market. This route has problems too, obviously, but it's better than what we do now. And I would certainly settle for it if the Congress felt you would not be able to sell those loans at a fair market price. It varies from program to program. For some of the loan programs, there really isn't a market that's worth anything.

With regard to guarantees, this plan would involve, in the best of circumstances, government going to the private market and trying to reinsure a loan to get the equivalent of private mortgage insurance to cover any future losses on the loan. Again, it's a question of whether a perfect market for that sort of thing would develop. If not, you can again make an administrative estimate of the present value, the expected value of any losses, and you get the issuing agency to deposit those monies into a Treasury fund to cover the losses. You again insist that the agency get an appropriation to cover that amount. So that brings to the situation a discipline that does not exist today.

From Fannie Mae to Farmer Mac

This sort of program should work for direct loans and guarantees, but what about these government sponsored organization? They are really a different animal, and it's much more difficult to figure out any way of controlling them. They are privately owned with private shareholders, but they are government chartered. In some cases, government appoints a share of the board of directors. In some cases, but not all, they have a line of credit from the Treasury, usually very small relative to their total liabilities. I think they have one major feature in common, and that is the belief in the marketplace that the government "ain't going to let these guys go broke no matter what they do." That's probably true.

So given that belief, they are able to borrow on favorable terms. An institution like Fannie Mae is able to

lever itself up to the hilt without paying a significant risk premium. But economic costs of these institutions are obvious. They make it harder for non-favored borrowers in the credit markets. They raise interest rates. But how do control them?

The government sponsored organization is going to be used more and more. It has been used recently to start bailing out the thrifts. It has been used recently to bail out the farm credit system. It's being proposed for small business. It could be a real growth industry.

The particularly worrisome aspect of it is in dealing with the thrift institution problem. Treasury is now concocting a plan that would have a government sponsored institution borrow probably up to $100 billion in the private marketplace. This wouldn't show up in the Federal budget at all. That borrowing would be guaranteed by zero purchase loans, the principle on the borrowing. The Federal government would pay the interest on that debt which would be on-budget. The interest would be on-budget, but the principle would not be.

And the tragedy of this approach — as opposed to just fessing up that we probably made the biggest mistake in the history of the U.S. government with these thrifts and going out and borrowing with regular Treasury bonds — is that while these government-sponsored institutions borrow on favorable rates, they still pay more than the government does, often *75 basis points or so on comparable debt*. So our attempts to hide this thrift fiasco and never to fess up in the budget to what it costs is ultimately going to cost the taxpayer one heck of a lot of money. But I'm afraid that's exactly how we are going to do it.

We have to think of a means of controlling these kinds of institutions or, better still, not create them in the first place.

* * * * *

CBO Baseline Deficit Projections and Targets

(By fiscal year)

	Actual	Base	Projections				
	1988	1989	1990	1991	1992	1993	1994
			(In Billions of Dollars)				
Baseline Projections							
Off-Budget Surplus[a]	$ 39	$ 56	$ 68	$ 79	$ 90	$ 103	$ 117
On-Budget Deficit	194	211	209	219	225	233	239
Total Deficit	155	155	141	140	135	129	122
Deficit Targets	144	136	100	64	28	0	[b]
			(As a Percentage of GNP)				
Baseline Projections							
Off-Budget surplus[a]	0.8%	1.1%	1.3%	1.4%	1.5%	1.6%	1.7%
On-Budget deficit	4.1	4.1	3.8	3.8	3.6	3.5	3.4
Total deficit	3.2	3.0	2.6	2.4	2.2	2.0	1.7
Deficit Targets	3.0	2.7	1.8	1.1	0.5	0.0	[b]

[a] Social Security (Old-Age and Survivors Insurance and Disability Insurance Trust Funds).
[b] The Balanced Budget and Emergency Deficit Control Reaffirmation Act set targets only through fiscal year 1993.
Source: Congressional Budget Office; Economic and Budget Outlook, January 1989.

Tax Reform a Big Hit Internationally in 1988

By lowering top income tax rates and limiting deductions in the Tax Reform Act of 1986, the U.S. seems to have struck up a beat that other nations are marching to; and 1988 is the year that our major trading partners have fallen in step.

Japan

Japan adopted major tax reform legislation that will slash income tax and excise tax rates and included a new 3 percent broad-based sales tax. Taking effect in April 1989, the new legislation will introduce substantial cuts in income, corporate, residence, and inheritance taxes, and tighten taxation on capital gains.

The lower income tax rates will range from 10 to 50 percent as compared to the existing 10.5 to 60 percent range, and there will be five income tax brackets instead of twelve. The base corporate tax rate will be reduced from 42 to 40 percent in fiscal 1989 and then cut further to 37.5 percent in fiscal 1990.

Great Britain

A major tax overhaul introduced with Great Britain's 1988 Budget went into effect in June. The basic rate of income tax was reduced from 27 to 25 percent, and the main personal allowances were increased by 7.5 percent. The upper income tax rate was set at 40 percent for people who make more than U.S. $35,700. The previous top rate was 60 percent for those earning more than U.S. $72,600.

West Germany

The Tax Reform Act of 1990 was approved July 8, 1988. It reduces West German income tax rates for both corporations and individuals. The highest individual rate was reduced from 56 to 53 percent, with corporate rates reduced from 56 to 50 percent. The tax reform focuses largely on personal taxes, as opposed to business taxes, and aims to spur savings and investment by cutting $10.67 billion from the national tax bill.

Canada

The Canadian Tax Reform of 1988 became law September 13, 1988. It reduced the number of personal income tax brackets to only 3 from the previous 10. The 3 brackets — 17 percent on the first Cdn $27,500 of taxable income, 26 percent on the next Cdn $27,500, and 29 percent on all taxable income above Cdn $55,000 — were established with most personal exemptions now converted to tax credits. The law also lowers the general Federal corporate tax rate to 28 percent from the current 36 percent and phases down the rate for manufacturing companies to 23 percent by 1991 from the current 30 percent.

THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

"Who Owns America?"

Foreign ownership of U.S. assets continues strong and growing, according to the Comerce Department's June 1988 *Survey of Current Business*. To wit:

❒ Foreign investment in the U.S. now totals $1.54 trillion.

❒ More than $344.4 billion of that is invested in corporate stocks and bonds.

❒ U.S. banks owe $539.4 billion to foreigners.

By the same token, it must be said that the United States is no piker when it comes to investing in other nations. The *Survey of Current Business* shows:

❒ Total U.S. assets abroad equal $1.17 trillion.

❒ 1.03 trillion of that is privately held.

❒ U.S. investors own more than $146.7 billion in foreign securities.

The bottom line, of course, is that the United States is in a negative position—*minus* $368.2 billion—as far as international investments go. This may be no reason to stand up and cheer. It is also no reason to weep and gnash our teeth.

For one thing, foreigners are investing in the U.S. because it is a desirable place to invest. We have a strong economy, a stable political system, a dynamic private sector, and a labor force that can produce with the best, given the right tools and equipment.

The problem is not that the U.S. is poor as a place to invest. It is that current tax policy does not encourage Americans to invest—i.e., save—in their own country.

Secondly, it is important to bear in mind that no matter what assets may be owned by foreigners, our dollars do not necssarily leave our shores. We are often talking about the allocation of ownership, not the removal of dollars. Leif H. Olsen, Chairman of the Tax Foundation's Shadow Budget Committee, enjoys telling what happened when J. Paul Getty decided to live in England in the years before his death. That simple choice to change residence caused a significant drop in the offially reported U.S. international investment position, even though Getty had not taken a dime with him when he relocated. It's not as if a fleet of container ships will pull up to a pier some day and haul off the nation's wealth.

A final consideration is that we live in a global economy. When the trade position of the European Economic Community (EEC) solidifies in 1992, we will find out precisely how global that economy is. Those are the rules of the game. Given a fair chance, the U.S. private sector has shown that it can compete successfully. It is up to the policy makers in Washington to see that they receive that chance.

Perhaps the new breeze blowing in our nation's capital will let in a little fresh air regarding two key areas affecting the nation's position in the world economy:

❒ Incentives for savings and investment.

❒ Tax policy that will aid rather than damage the competitive position of U.S. companies.

(FEDERAL TAXES, *from page 2*)

before the IRS. It also requires the Service to establish formal guidelines for what constitutes a reasonable time and place for a taxpayer's interview. Furthermore, the IRS is now prohibited from evaluating the performance of its employees involved in collections by setting quotas for amounts to be collected. The Taxpayer Bill of Rights now gives taxpayers a 30-day "grace period" after notice of intent to levy before the IRS can seize a bank account and increases the amount of property and wages exempt from collection action. Finally, the IRS is given authority to allow installment tax payments if the agreement would facilitate the collection of taxes owed.

. . . the Catastrophic Coverage Act will require senior citizens to pay an additional $19 billion to the IRS over the next five years.

With the passage of the Technical and Miscellaneous Revenue Act of 1988, many of the numerous drafting errors in TRA'86 that bestowed unexpected benefits upon some taxpayers while imposing unintended liabilities upon others were finally resolved. For many individual and corporate taxpayers, TAMRA means more certainty in tax planning than has been possible since passage of TRA'86.

Welfare Reform

In October of 1988, President Reagan signed into law the Family Support Act of 1988. While the main purpose of the new Support Act is to reform the welfare system, it will also have a major tax impact on many individual taxpayers because a portion of the $3.3 billion expense of the bill will be covered through a variety of tax moves. Beginning in 1989, taxpayers claiming the child-care tax credit will be required to report the name, address and social security or other taxpayer-identification number of the child-care provider. This tightening provision is expected to raise $529 million in tax revenues over the next five years from babysitters who are not fully reporting their incomes. Another $25 million is expected to come from taxpayers who must now furnish social security numbers for dependents as young as two years, down from five years under previous law. The new law lowers the maximum age of dependents for whom taxpayers can claim the child-care tax credit raising an estimated $375 million over a five-year period. The largest share of funding for the $3.3 billion welfare reform will come from extending for five years an expiring IRS program under which money owed to the government is deducted from income-tax refunds.

Windfall Tax Repealed

With the passage of the Omnibus Trade Bill, August 23, 1988, the Crude Oil Windfall Profit Tax Act of 1980 was repealed. The act had imposed an excise tax on oil revenues, above a statutory base, that were expected to result from the projected increase in oil prices. However, with reduced and stabilized oil prices the windfall profit tax raised little revenue after 1986 and cost over $100 million annually to administer. Manufacturers and consumers alike will benefit from the repeal of the windfall profit tax, which was viewed as a disincentive to exploration and production of domestic crude and as posing burdensome recordkeeping expenses on producers.

Proceedings of a 1988 Tax Foundation Seminar

"The U.S. Stake in U.S. Foreign Investment"

on tax policy and its effect on U.S. competitiveness abroad will be available in March

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TAX·FEATURES

Overall Tax Burden Proportional To Income, New Study Confirms

Cost of Congress Passes $2 Billion, Dwarfing $29 Million Savings On Recently Rejected Pay Raise

Recent debate over a $29 million pay raise for members of Congress created a firestorm. That raise is a drop in the bucket compared to the more than $2 billion taxpayers will shell out to fund the operations of the nation's legislative body during fiscal year 1989, according to economists at the Tax Foundation, a Washington-based tax research organization.

Overall spending on the Legislative Branch is estimated to rise $381 million in FY 1989, hitting an all-time high of over $2.2 billion. That 21 percent jump far surpasses the estimated 7 percent increase in total Federal spending for FY 1989.

The cost of Congress itself, now at nearly $1.1 billion, has risen a whopping 81 percent since 1980. To run the Senate and House of Representatives will top the $1 billion mark this year—six times the cost in 1970. The Senate will run taxpayers $356.6 million ($3.6 million per Senator), while the House will require $565.4 million ($1.3 million per Representative). Joint activities of the

(Continued on page 6)

Seminar Proceedings Available

The Tax Foundation has published the proceedings of the seminar on *The U.S. Stake in U.S. Foreign Investment* held last September. Members of the business community, media, government, and academia examined the critical role of U.S. investment abroad and the need for a more competitive national policy, particularly in view of the economic harmonization of Europe in 1992. A copy is $10 ($5 for TF members), plus $2 p/h.

In a related development, the Institute for Research on the Economics of Taxation (IRET) has released a survey of Fortune 500 companies and members of the American Business Conference on the value of operating abroad for international competitiveness and assessing U.S. foreign tax policy. It reveals that U.S. businesses would often have to **reduce** their domestic employment, investment, R&D, and exports if they were unable to operate abroad. Entitled *A survey of American Business on American Foreign Tax Policy*, it is available from IRET at 1331 Pennsylvania Avenue, N.W., Suite 515, Washington, DC 20004, 202-347-9570.

The overall U.S. tax burden's distribution is roughly proportional, although families at the very top and bottom of the economic ladder bear a disproportionate share of the tax load. This is the conclusion of the *Tax Burden by Income Class, 1986-1987*, a major study recently conducted by Tax Foundation economists. Foundation analysis also shows that different types of taxes impose heavier burdens on families at the ends of the income scale.

"Individuals and policy makers must understand clearly how the tax burden affects households of various income levels in order to approach any tax modifications equitably and efficiently," the study states.

The study points out that "the current demand for increased government services, combined with a severe Federal budget deficit and budgetary problems in numerous states, creates a fiscal environment ripe for revenue enhancement." Before such increases are proposed, the study cautions, policy makers must ask what types of taxes could be implemented to most effectively address these fiscal demands and who will bear the burden.

(Continued on page 5)

Overall Tax Burdens as a Percent of Income By Income Class, 1986

Income Class[a]	All taxes	Federal taxes	State and local taxes
Less than $10,000	49.54%	23.74%	25.80%
$10,000 to $14,999	34.38	18.55	15.82
$15,000 to $19,999	34.04	19.28	14.76
$20,000 to $29,999	32.86	19.58	13.28
$30,000 to $39,999	32.14	19.87	12.27
$40,000 to $49,999	32.89	20.63	12.26
$50,000 to $59,999	31.44	19.60	11.84
$60,000 to $69,999	35.02	22.77	12.26
$70,000 to $89,999	31.28	19.82	11.46
$90,000 and over	51.59	37.93	13.66
All income classes	35.53%	21.89%	13.64%

[a] Money income before personal taxes.

THIS ISSUE:

PAGE 1:
Tax Burden Study
Cost of Congress
PAGE 2:
Fate of the Median Family's Tax Dollar
PAGE 3:
"Budget Watch"
PAGE 5:
"Front Burner"
INSERT:
Tax Gap
1989 Tax Increases

Moderate Income American Family Will Pay Total Federal Taxes of $14,068 in Fiscal 1989

A moderate-income family—two workers earning $45,000 with two dependent children—faces a tax bill of $14,068 for fiscal year 1989. That covers the family's direct and indirect Federal taxes. Add to this its $2,391 "share" of the Federal deficit, and the family would contribute $16,495 to support the estimated $1.1 trillion Uncle Sam plans to spend in fiscal year 1989.

Economists at the Tax Foundation use this prototypical family to show where the average American household's Federal tax dollars will go. Assuming that the $14,068 tax bill is allocated to cover the family's entire share of Federal spending, the following expenditures stand out:

- Income security tops the list at $369.3 billion. This comprises Social Security, Federal retirement, unemployment compensation, housing assistance and nutrition assistance and will extract 31 cents for each $1 this family sends to Washington, or $4,426.
- National defense will cost $298.3 billion—or 25 cents out of each tax dollar. For the moderate-income family, this amounts to $3,573.
- Interest on the public debt ranks third at $165.7 billion, costing a family over 14 cents of its tax dollar, or a whopping $1,985.
- Health outlays, mainly Medicare and Medicaid, will take 12 cents of each tax dollar. The typical family will send Uncle Sam $1,636 to pay for the $136.5 billion national health bill.

These four programs alone will claim almost 83 percent of all Federal spending and will cost this moderate-income family $11,620, or 83 cents of each tax dollar. With the remaining 17 cents, Uncle Sam will, among other things, spend approximately 3 cents on education and less than 3 cents each on transportation, agriculture, and administration of justice.

The Family Tax Bill

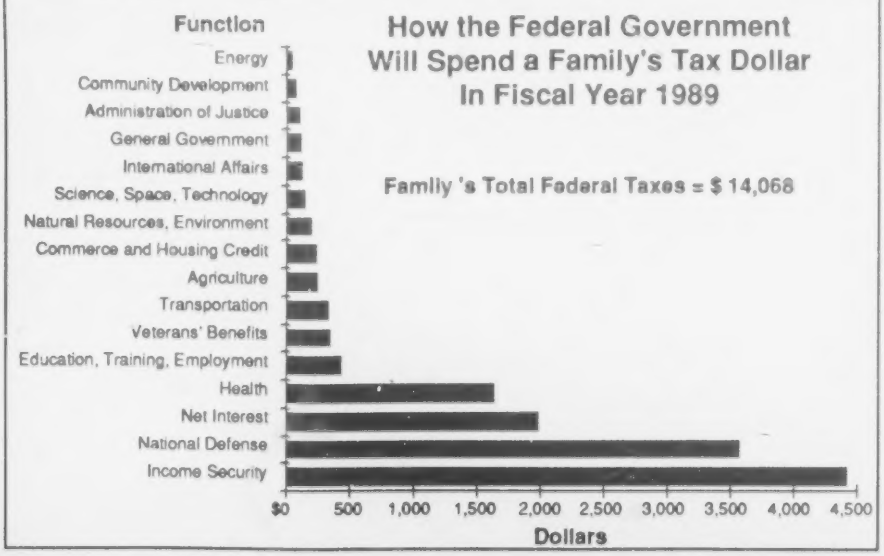
Direct Federal taxes—individual income and personal social security taxes—will cost this family $8,760 in 1989. However, direct levies do not explain the whole tax picture, accounting for only about three-fifths of the

(Continued on page 5)

How the Federal Government Will Spend A Family's Tax Dollar in 1989[a]

Function	Family's Share		Total Spending (Millions)
	Amount	Percent of Total	
Income Security[b]	$ 4,426	31.46%	$ 369,281
National Defense	3,573	25.40	298,255
Net Interest	1,985	14.11	165,704
Health[c]	1,636	11.63	136,495
Education, Training, Employment, Social Services	436	3.10	36,351
Veterans' Benefits and Services	350	2.49	29,218
Transportation	336	2.39	28,027
Agriculture	250	1.78	20,903
Commerce and Housing Credit	241	1.71	20,040
Natural Resources and Environment	197	1.40	16,487
General Science, Space and Technology	151	1.07	12,593
International Affairs	129	0.92	10,748
General Government	120	0.85	9,990
Administration of Justice	113	0.80	9,428
Community and Regional Development	76	0.54	6,303
Energy	49	0.35	4,137
Total[d]	$ 14,068	100.00%	$ 1,137,030
Exhibit:			
Payments for Individuals	$ 6,405	45.53%	$ 534,473

[a] This example uses a two-earner family earning $45,000 per year with two dependent children.
[b] Includes social security, Federal employee retirement, unemployment compensation, housing assistance, and food and nutrition assistance; excludes veteran's income security.
[c] Includes Medicare, Medicaid, and others; excludes veterans' hospital and medical care.
[d] After deducting $36,931 million in undistributed offsetting receipts not classified by function.
Source: Tax Foundation computations based on Fiscal Year 1990 U.S. Budget presented in January 1989, and tax laws for 1989 from the Treasury Department.



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Budget Watch By Allen Schick

George Bush's First Budget Is Not the Last Word on the Subject

Less than three weeks after he took office, Gorge Bush presented his budget plans for the next (1990) fiscal year to Congress. The new President's budget was distinguished both by the speed with which it was prepared and the lack of concrete information on how more than one trillion dollars of Federal money would be spent. Almost 40 of the 190 pages in the budget document were completely blank and another 30 pages had only a few words. No details were provided on how the $300 billion proposed for defense would be allocated, or on how more than $10 billion would be squeezed out of domestic programs.

This article fills in some of the blanks by discussing five issues that will determine what happens in the next year and beyond. These are relations between the President and Congress, the "no new taxes" pledge, the drive to cut Federal spending, the need to meet deficit reduction targets, and the outlook for the economy.

"The new President's budget was distinguished both by the speed with which it was prepared and the lack of concrete information on how more than one trillion dollars of Federal money would be spent."

(1) The real budget will be negotiated with Congress, not dictated by the White House.

The gaps in the budget were put there on purpose. Bush's new style budget is only the opening round in a series of negotiations that might eventuate in decisions that will shape national priorities for the remainder of the 20th century. It reflects a transformation in Federal budgeting that began before the Reagan presidency and is continuing afterwards. At one time, not very long ago, the President's budget was the authoritative benchmark against which Congress measured all its revenue and spending actions. This is no longer the case. Today, the President prepares a budget with an eye on the ensuing negotiations and he does not, therefore, reveal his true preferences in the figures submitted to Congress.

"Today, the President prepares a budget with an eye on the ensuing negotiations and he does not, therefore, reveal his true preferences in the figures submitted to Congress."

Budgeting-by-negotiation has occurred several times in the 1980s, most recently after the stock market crash in October 1987. It is the nature of these negotiations that neither the process nor the outcome can be scripted in advance. The rules are made up as the discussions proceed, and the pace depends on the tactics used by the two sides. The first half year or longer of the Bush presidency might be dominated by deficit worries and budgetary conflict with Congress. The betting this year is that an agreement will be reached before any Gramm-Rudman-Hollings cuts are made. When an agreement comes, it is likely to be a multi-year package that covers taxes, spending priorities, and deficit targets.

(2) Bush means what he said about taxes during the campaign, but taxes still might rise.

For many months, Bush has insisted that Americans "read my lips"; now they can read his words as well. If Bush has his way, taxes will not be increased in 1989, though there might be some new user charges and other "revenue enhancements." Congressional Democrats are beginning to believe Bush's "no new taxes" message, but they are not convinced that he will be able to stay with it when the Gramm-Rudman-Hollings process is activated this summer. Bush's proposal for a reduction in capital gains taxes might provide maneuvering room for a deal in which a preferential rate on this source of income is coupled with some tax increases.

"Congressional Democrats are beginning to believe Bush's 'no new taxes' message . . . ."

Bush's budget repeatedly emphasizes that even without a tax increase, Federal revenue would rise some $80 billion next year if the economy performs as projected. The point to keep in mind is that a healthy economy adds more to Federal revenue than a tax increase; a weak economy takes away revenue even if Congress enacts a tax increase.

(3) Spending priorities will be the major budget conflict.

The new President's budget is faithful to another campaign pledge: a flexible spending freeze. The basic concept of the freeze is that total spending should rise no more than the rate of inflation, but that within this total, some programs might have bigger increases and other would have smaller ones. For bargaining purposes (and also to show compliance with the deficit targets) the Bush budget purports to constrain total spending well below freeze levels. His budget, the

(Continued on page 4)

(BUDGET WATCH, *from page 3*)

table accompanying this article shows, calls for barely a one percent rise in spending, which would be well below the rate of inflation projected for next year. Some modest spending increases are sprinkled throughout the budget for space exploration, education, the environment, the war on drugs, and a few other high-priority areas. To offset these increases, Bush identifies a number of cuts, the biggest one being in Medicare. However, another $10 billion, or more, in unidentified savings

"Bush identifies a number of cuts, the biggest one being in Medicare."

will have to be made if the spending target is to be reached. These unidentified cuts are a throwback to the "magic asterisk" which hobbled Ronald Reagan's commitment to balance the budget eight years ago.

The difficulty—some might say impossibility—of meeting the spending targets is evident from the entries in the table. The four biggest chunks in the budget (defense and international programs, social security and Federal pensions, interest payments, and Medicare/Medicaid) account for 80 percent of total outlays. The cost of these programs is likely to grow at least $40 billion next year. This means that spending in the remainder of the budget will have to be cut substantially below the fiscal 1989 level in order to meet the spending target. One of the tricks used to show a sizeable reduction in FY 1990 spending is to load virtually all of the cost of the savings and loan crisis on the 1989 budget and on the 1991 and subsequent fiscal years. According to official budget figures, the savings and loan crisis will actually "save" $10 billion in the next fiscal year.

The overwhelming odds are that total spending will end up well above the projected level. Some of the unbudgeted rise might be due to economic conditions, some to the evaporation of unidentified cuts, and some to congressional actions. The President will blame Congress for the add-ons, but this won't stop Capitol Hill from negotiating a budget agreement with the White House.

(4) If the spending target is unreachable, the deficit target will also be beyond reach.

President Bush managed to shoehorn his budget into the $100 billion GRH deficit target for fiscal 1990. This was no easy feat because the latest estimates are that the 1989 deficit will exceed $160 billion. In fact, 1989 will be the second consecutive year of rising deficits. While it is unlikely, one should not be surprised if 1990 makes it three years in a row.

In the arcane world of Federal budgeting, all it takes to avoid sequestration under the Gramm-Rudman-Hollings law is to project a declining deficit. It is not necessary to actually produce any deficit reduction. With a little luck and a lot of deception, it might be possible to avoid a GRH sequester this summer. The task will be much harder a year from now because GRH calls for the 1991 deficit to be no higher than $64 billion. This is where the budget summit mentioned earlier might come to the rescue. As part of a package deal, the GRH targets might be stretched out to require less deficit reduction in the years immediately ahead. Instead of schedul-

"President Bush managed to shoehorn his budget into the $100 billion GRH deficit target for fiscal 1990. This was no easy feat because the latest estimates are that the 1989 deficit will exceed $160 billion."

ing a balanced budget in 1993, as the law now provides, Americans might have to wait until the year 2000 when tomorrow's politicians will be blaming today's leaders for their budget woes.

(5) The economy will have the last word.

The performance of the economy will exert more influence over the fate of the budget than will presidential and congressional negotiators. The Bush budget is predicated on continuing vigor in the economy, falling interest rates, moderate inflation, and rising productivity. At present, interest rates appear to be the most vulnerable projection. Any variance from the projected level will have a direct and immediate impact on total outlays and the deficit.

With the economy enjoying the 7th consecutive year of expansion, President Bush does not want to make jarring policy changes that might risk a downturn. He wants to stay on the Reagan budget course but temper it with kinder and gentler social policies. If he succeeds, we might be entering a new era of good feeling in Washington with declining deficits and more money for domestic needs; if he doesn't, the budget will be as contentious in the 1990s as it has been in the 1980s.

Comparison of Fiscal 1989 and 1990 Estimated Outlays
(billions of dollars)

	1989	1990
Defense/International Programs	$ 309	$ 318
Social Security/Federal Pensions	284	299
Interest Payments	169	173
Medicare/Medicaid	121	132
Subtotal	883	922
Savings and Loan and Bank Insurance	15	[a]
Everything Else[b]	285	278
Offsetting Receipts	-40	-40
Total Outlays	1,143	1,160

[a] Less than $500 million.
[b] Everything else includes space, science, energy, agriculture, housing, employment, community development, environment, nutrition, education, social services, transportation, law enforcement, welfare assistance, medical research, veterans benefits, and the operations of most Federal agencies.
Source: Building a Better America, February 9, 1989.

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy

MARCH 1989

Cautions on the Tax "Gap"

Summary

■ IRS estimates of a huge income tax compliance gap between what is voluntarily paid and what is owed may be used by Congress and the new Administration to frame deficit reduction proposals. This is likely even though the Commissioner of the Internal Revenue Service has cautioned that the estimates should not be measures of the "potential for additional enforcement yields." The gap estimates include amounts eventually collected through audit and amounts "not cost effective to collect." The latter comprise a large segment of the individual income tax compliance gap.

■ The gross income tax gap estimates clearly overstate the compliance problem to the extent they are based on IRS examiners' recommendations rather than actual assessed amounts.

■ The official tax gap estimates may greatly exaggerate the compliance problem in the corporate sector, particularly for large corporations. The methodology of projecting the gap statistics with respect to large corporations is suspect. More importantly, much of the large corporate sector is subject to near 100 percent audit coverage anyway. Whether these factors will be recognized in any Congressional consideration of deficit reduction is unknown.

Last year there was considerable publicity about the $84.9 billion tax compliance "gap" as estimated by the Internal Revenue Service for 1987. The gross tax gap is the amount of *income tax* owed but not voluntarily paid because of understatement of income, overstatement of deductions and credits, or simply nonfiling. As such, it does not reflect IRS enforcement actions which would tend to lower the reported gap. Nor does the compliance problem with employment and excise taxes or taxes lost in the illegal sector of the economy, both of which would tend to raise the gap.

The 1987 income tax gap was estimated at $63.5 billion for individuals (75 percent), and $21.4 billion for corporations (25 percent). The individual tax gap was the equivalent of $642 per individual tax return with taxable income. In other words, *if* the legal sector individual tax gap were totally eliminated somehow, individuals who did report taxable income correctly theoretically could pay an average of $642 less and the Treasury would still receive the same net revenue.

During the Presidential campaign the tax gap concept became something of an issue because Governor Dukakis repeatedly called attention to it as a source of additional Federal revenue not requiring higher rates or other new tax burdens. He also touted the revenue raising potential of a Federal tax amnesty, citing the very "successful" tax amnesty program in Massachusetts several years ago.

Because Governor Dukakis was not successful in his presidential bid does not mean the issue will go away. President Bush's well-known aversion to new taxes and looming Gramm-Rudman-Hollings deficit reduction deadlines could lead his Administration to new proposals to recapture part of that $85 billion. Furthermore, Congress on its own has shown no hesitancy to plunge into compliance improvement schemes at least when the prospect of additional dollars can be danced in front of it.

Questioning the Dollar Yield

For many years the IRS simply refused to attach any dollar estimates to the compliance problem. To admit that a substantial gap existed might be counterproductive of voluntary compliance by honest tax payers. Also it implied a failure of tax administration, which was, undoubtedly, the more important reason for not publicizing any gap.

However, prodded by Congressional pressure, the IRS had a change of heart in 1979, and then Commissioner Jerome Kurtz initiated the tax gap studies. There have been three basic studies done — in 1979, 1983 and 1988. The first was limited to unreported income of individuals including an attempt to measure income taxes lost because of illegal activities. The study was expanded to corporations and overstated deductions in 1983. The 1988 study updated the figures and refined the methodology used in 1983. Also, it was deemed impractical to try gauge any part of the tax gap from illegal activity.

In describing the 1988 study to the House Ways & Means Subcommittee on Oversight, Commissioner Lawrence Gibbs emphasized that the tax gap estimates "are not intended to be measures of the potential for additional enforcement yields.: This is because the gap includes amounts which are ultimately collected under the audit and other enforcement actions and

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amounts which would not be "cost effective" to collect. In the latter case, he is referring to such long recognized practices as "working off the books" whereby craftsmen and entrepreneurs of all stripes may supplement their incomes by occasional "cash only" jobs. Without any paper trail, there is simply no effective way to levy income taxes on these transactions, which are typically small individually but could be vast collectively. In fact, the taxes lost in unreported income in the categories of "informal suppliers" and other non-farm proprietor income were estimated at $24.4 billion in 1987 or 51 percent of the total tax loss in individuals' unreported income, which, in turn, accounted for 57 percent of the total income tax gap. Obviously, therefore, a significant part of the latter is not collectable and cannot be considered a potential deficit reduction source.

Recommended vs. Assessed

Another uncertainty in the revenue raising potential with regard to the tax gap is the fact that the gross estimates are based on the *recommendations* of IRS examiners in the audit process. But in cases where the appeals process *reverses* the examiners' recommendations in whole or in part, the real tax gap obviously should shrink. The service has presented some alternative gap estimates based on *assessed* amounts of additional tax after appeals rather than the recommended amounts. These are quite revealing. As indicated in the table below, the gross tax gap for 1987 would shrink from $84.9 billion to $71.2 billion with the drop split about evenly between individuals and corporations. As a result the voluntary compliance rate for corporations would improve approximately five percentage points to 87.0 in 1987, above that reported for individuals. Reversals of examiners' recommendations are proportionately more significant in the corporate sector where decisions involve substantial sums.

It would seem logical to use the assessment basis for more realistic tax gap estimates. However, the IRS claims that the alternative assessment-based estimates are not available by source and that they cannot account for cases where the Service will settle for less than full liability — or the taxpayers may not appeal — simply to avoid litigation "hazards and costs."

In any event, the featured tax gap estimates continue to be based on examiner recommendations which clearly overstate the true gap.

Controlling Assumptions

All tax gap data ultimately depend on the audit system. In the case of individuals and small corporations (under $10 million in assets), sample audit data is collected and processed through the Tax Compliance Measurement Program (TCMP). For individuals this is conducted every three years using a probability sample of approximately 50,000 returns. For large corporations there is no TCMP data, but for virtually all of them over $100 million in assets there is close to 100 percent audit coverage anyway.

Audit data, whether through the TCMP samples or direct, is not very timely. The 1988 tax gap study uses TCMP data for individuals only through 1982. The Statistics of Income and Estimates of the Treasury's Office of Tax Analysis are used to extend reported individual tax liabilities through 1985 and to project them to 1992. The Service must then assume a very critical voluntary compliance rate to apply to the reported

Gross Tax Gaps and Voluntary Compliance Rates
1973-1992

	1973	1976	1979	1982	1985	1986	1987	1988	1992
Gap Based on Examiners' Recommendations									
Tax Gap ($billion)									
Total	$ 28.4	$ 40.7	$ 61.7	$ 62.6	$ 87.8	$ 95.0	$ 84.9	$ 87.1	$ 113.7
Individuals	19.7	29.6	46.8	51.9	73.3	79.3	63.5	64.3	82.6
Corporations	8.8	11.1	15.0	10.7	14.4	15.6	21.4	22.8	31.1
Voluntary Compliance Rate (percent)									
Total	83.7%	82.4%	81.7%	83.4%	81.6%	81.1%	83.2%	83.6%	84.2%
Individuals	84.6	82.6	81.8	83.7	81.6	81.0	83.5	84.0	84.9
Corporations	81.3	81.6	81.3	81.8	81.7	81.7	82.5	82.4	82.5
Gap Based on Assessed Amounts									
Tax Gap ($billion)									
Total	$ 23.7	$ 34.2	$ 52.0	$ 53.9	$ 75.5	$ 81.1	$ 71.2	$ 72.8	$ 95.0
Individuals	17.5	26.3	41.4	46.3	64.8	70.1	56.1	56.8	73.1
Corporations	6.2	7.8	10.6	7.6	10.7	11.0	15.1	16.0	21.9
Voluntary Compliance Rate (percent)									
Total	86.0%	84.8%	84.1%	85.3%	83.8%	83.4%	85.6%	85.9%	86.6%
Individuals	86.1	84.3	83.6	85.2	83.4	82.9	85.1	85.6	86.4
Corporations	85.9	86.2	86.0	86.3	85.8	86.4	87.0	86.9	87.1

Source: Income Tax Compliance Research, Internal Revenue Service, March, 1988.

liability figures to come up with estimates of the post-1982 tax gap. The estimating process is different for large corporations but with similar time lags between actual audit data and gap estimates.

Such assumptions can make a big difference in the published figures. In the 1983 study it was assumed that the overall voluntary compliance rate would decline in the future and this would result in a total gap of $115 billion by 1987, over $25 billion higher than now estimated for that year. Legislative changes in tax liabilities and other factors also affected the outcome, but the compliance rate assumption was critical. In the 1988 study the IRS basically assumed there would be no change in compliance rates across types of return or types of income. Holding the compliance rates constant means that the gap estimates for the future depend almost entirely on changes in tax liability by sector (although changes in the composition of income types also could change the rate slightly).

This has implications for the distribution of the gap estimates because the Tax Reform Act of 1986 loaded an estimated $120 billion of additional liabilities on the corporate sector. That sector, therefore, automatically is assumed to have a lot bigger compliance problem. In fact, the 1986 Act was by far the biggest factor in the $10 billion increase in the reported corporate sector tax gap for 1987 as between the "old" 1983 study estimate and the "new" 1988 study estimate. Conversely, because individual tax liabilities were reduced by the 1986 Act, the individual gap estimates were reduced.

There is something troubling about this link-up. The IRS claims that data limitations force it to use rather arbitrary compliance rates for long periods. The implication, however, of the published figures is that there is growing noncompliance wherever liabilities enlarge. In other words, if you have incurred increased tax burdens, from increased income and/or legislative penalties, you have more opportunity to "not comply voluntarily" and you will do so regardless of other factors.

One of those factors was the 1986 repeal of the investment credit which was estimated to increase corporate tax liabilities by $113 billion over five years. (Recall that the net increase in total corporate liabilities under the 1986 Act was $120 billion.) Logic would indicate certainly that this would not cause an increase in noncompliance. Quite the contrary, voluntary compliance should improve without all the extensive past disputes between business taxpayers and the Service as to qualification for the credit, etc. Yet the arbitrary compliance assumptions allow no recognition of this for current and future corporate gap estimates.

There is yet another twist to the estimating procedure that seems to stack the deck against the corporate sector. As noted before, the individual and small corporation gap estimates are derived from the TCMP data of earlier years. To arrive at a compliance rate the Service first calculates what it calls "voluntary reporting percentages" for each tax return line item. It is these reporting percentages which are held constant based on 1982 experience. Then for the individual sector some adjustments were made to reflect the legislative changes under the Tax Reform Act of 1986 on each item reported, and adjustments also were made for compliance improvement provisions under other legislation. This tended to increase the reported compliance rate in the individual sector. Even though the voluntary reporting percentages do not change, the overall individual compliance rate is expected to increase slightly further because of changing composition of individual items and the legislative adjustment.

For large corporations with over $10 million in assets, the service claims that voluntary reporting percentages for income and deduction items cannot be calculated. Therefore, it applied a "composite" estimated compliance rate for all years with no adjustment for any compliance improvement provisions. The Service admits this is not a satisfactory procedure and that the corporate estimates therefore are "particularly subject to uncertainty." In fact, in footnotes and in a chapter on methodology the Service's 1988 study appears to concede that an alternative calculation would be more realistic. This would result in a rise in the corporate compliance rate and a narrowing of a corporate tax gap. But the alternative calculation did not make it into the published figures.

Large Corporation Audit Coverage

Finally, there is an overriding question about the large corporation tax gap, reported to be $15.8 billion or about 75 percent of the total corporate sector gap in 1987. Recall that the "gap" consists of taxes owed but not voluntarily paid. But for corporations with assets over $100 million — which must comprise a very large portion of the large corporation category in both dollar volume of liabilities and estimated tax gap — audit coverage is very close to 100 percent. Whether audit adjustments involve correction of errors or different interpretation of tax provisions, the Treasury ultimately will be paid what is owed with interest. Yet the published figures show the corporate sector gap rising from $9 billion in 1973 to $21.4 billion in 1987, and projected at $31.1 billion in 1992. Part of the growth in the tax gap here is simply in the economy and corporate profits. But year-after-year listing of a generally expanding corporate tax gap may be misleading when the amounts recovered through the audit process are not reflected. There doesn't appear to be any recognition of this in the published reports.

* *

Tax gap statistics may be useful for a general understanding of the extent of the compliance problem. To be sure, we do have a very significant compliance problem. Some further selective enforcement programs probably could help to reduce it. However, the gap data have severe limitations and, particularly in the case of the corporate sector, there is significant question as to what the published figures really mean. It is not just an academic exercise. Congress may look at these large figures and their distribution with the budget deficit very much in mind despite Commissioner Gibbs' admonition not to do so.

1989 TAX INCREASES HAVE ARRIVED!

Those who believe they will not see Federal tax increases in 1989 are apparently unaware that such increases are already here. Thirteen separate tax bills passed since the major Reagan tax cut under the Economic Recovery Tax Act (ERTA) in 1981 will pull $146.6 billion from taxpayers' pockets in FY 1989.

Over $95 billion will come from individual income taxes and corporate income taxes alone. The remaining $52 billion will come primarily from increased social insurance taxes, excise taxes, customs duties, and miscellaneous fees. The table below breaks down the revenue by legislation.

Federal Revenue Impact of Revenue Raising Legislation, 1982-1988 Individual, Corporate, and Total Impact in 1989[a]

(Budget Effect in Billions of Dollars[b])

Legislation	1989
Tax Equity and Fiscal Responsibility Act of 1982 - Total	$ 55.7
Individual Income Tax	15.9
Corporate Income Tax	38.5
Highway Revenue Act of 1982 - Total	5.1
Social Security Amendments of 1983 - Total	30.9
Railroad Retirement Revenue Act of 1983 - Total	1.1
Deficit Reduction Act of 1984 - Total	27.7
Individual Income Tax	16.0
Corporate Income Tax	10.6
Consolidated Omnibus Budget Reconciliation Act of 1985 - Total	3.0
Individual Income Tax	0.2
Corporate Income Tax	-0.1
Omnibus Budget Reconciliation Act of 1986 - Total	2.0
Individual Income Tax	0.7
Corporate Income Tax	0.1
Superfund Amendments and Reauthorization Act of 1986 - Total	0.8
Individual Income Tax	-0.2
Corporate Income Tax	0.4
Continuing Resolution for 1987 - Total	3.0
Individual Income Tax	1.4
Corporate Income Tax	1.4
Omnibus Budget Reconciliation Act of 1987 - Total	13.9
Individual Income Tax	0.4
Corporate Income Tax	6.0
Continuing Resolution for 1988 - Total	2.7
Individual Income Tax	1.1
Corporate Income Tax	1.6
Medicare Catastrophic Coverage Act of 1988 - Total	0.6
Individual Income Tax	0.6
Family Support Act of 1988 - Total	0.1
Total Tax Increases[c]	$146.6
Individual Income Tax	36.1
Corporate Income Tax	58.5
Social Security, Excise, Customs, and Misc.	52.0

[a] Totals include the effect on all tax sources, i.e. individual income, corporate income, Social Security, excises, estate and gift, customs and miscellaneous receipts.

[b] Budget effect revenue estimates are prepared by the Office of Management and Budget for the purposes of the budget presentation. They measure only the direct effect of tax legislative changes on receipts with feedback effect limited to the overall income forecast and its impact on receipts by major source. Budget estimates reflect actual economic experience or revisions in the economic forecast; the original legislative intent estimates do not.

[c] Presents post-1981 legislation that, in total, increases FY1989 tax revenues. Not included are: Interest and Dividends Tax Compliance Act of 1983 (-2.0 billion); Federal Employees' Retirement System Act of 1986 (-0.2 b.); Tax Reform Act of 1986 (-24.4 b.); and Technical and Miscellaneous Revenue Act of 1988 (-0.4 b.).

Source: Office of Management and Budget, Budget of the United States Government for fiscal years 1981 through 1990.

(TAX BURDEN STUDY, *from page 1*)

While the overall tax burden is roughly proportional, with an average tax burden of 35.53 percent, the study notes, "both the lowest and highest income classes absorb a greater total tax burden at 49.54 percent and 51.59 percent, respectively."

Income Taxes Hit the Wealthy

Raising a specific type of tax dramatically affects the tax burden of particular income classes. As might be expected, families with the most income pay a much larger share of the income taxes to Federal, state and local governments. In fact, their Federal individual income tax burden is almost eleven times greater than the lowest.

Excise Taxes Target the Poor

Low-income families pay out a much larger share of income as excise taxes, social insurance and property taxes than do the average or high-income families. The Federal tobacco tax burden for low-earning families is over five times greater than for the highest. "In total," the study observes, "the sales and excise tax burden is over five times greater for the lowest income families than for the highest."

Tax Burden by Income Class, 1986-1987 expands upon an earier tax burden analysis presented in the Tax Foundation's 1981 study *Allocating Tax Burdens and Government Benefits by Income Class, 1972-73 and 1977*. The new study focuses exclusively on tax burdens and is the first such study to be done using comprehensive and detailed 1986 Consumer Expenditure Survey data on family income and consumption. It summarizes the results of a detailed analysis of the distributional impact of Federal, state, and local taxes by income class. A detailed breakdown by type of tax illustrates the tax burden of each tax by income class.

Copies of *Tax Burden by Income Class, 1986-87* are available from the Tax Foundationfor $10.00, plus $2.00 postage and handling. An expanded version containing all exhibits, alternative assumptions, and bibliographic data is also available for $20, plus $2.00 postage and handling.

THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

"Who Pays the Taxes?"

Ours is a moderately progressive income tax system—for the most part. This fundamental premise of the convential wisdom has been pretty well borne out by a major research undertaking just completed by Tax Foundation economists and reported on elsewhere in this issue.

There has long been a tacit understanding among Americans that those who benefit more from our society should lend a helping hand to those further down the ladder by paying a progressively larger share of the costs of government. At times, in the post World War II era, that progressivity got out of hand with rates on top earners that approached the confiscatory. During the current decade, the White House and the Congress have made important strides in redressing that balance. True, much of the burden of paying for the rate cuts under the Tax Reform Act of 1986 was shifted to the business community. True, major issues remain to be resolved, among them our national blindness to the need to promote savings, capital formation and international competitiveness.

Still, most unbiased observers will concede that the Federal tax system is more balanced today than it has been in a long time. The question is, where do we go from here?

For one thing, the study makes it clear that we cannot continue a policy of "rich bashing" in the income tax code. Top earners are already taking the largest hit in the amount of income pre-empted for taxes. Tax writers, like bankrobber Willie Sutton, always go where the money is. And when it comes to income taxes, there just isn't enough money at the top to do the job.

At the other end of the spectrum, we must, as a nation, address the concerns of those families whose income is so heavily eroded by sales and excise taxes and by the ever-burgeoning costs of social insurance programs. It's always easier to pass "sin" taxes. But is it wiser? Is it good policy? Advocates of big government see no problem in siphoning off the earnings of the working poor and near poor to fund costly, wasteful, ineffective and obsolete programs under the questionable assumption that Big Brother knows our needs and will take care of us.

For all the "reform" we have seen during the current decade, all too often, rational tax policy and sound long-term planning for government's revenue requirements go out the window when the need to fund programs comes in the door. This kind of nonsense must stop. There is no longer an economic cushion to compensate for sloppy thinking, porkbarrel politics or poor planning.

The agenda is there for the new Administration and the new Congress. A nation grown increasingly cynical waits and watches to see how that agenda will be adressed in the coming months.

(MEDIAN FAMILY, *from page 2*)

total Federal tax take. To these must be added such indirect taxes as the employers' share of Social Security taxes; corporate income taxes; excise taxes on such items as gasoline, liquor and tobacco; and miscellaneous levies. These will take another $5,308 from the moderate-family's income.

Direct and indirect Federal taxes claim over 31 percent of this family's annual income, but even that does not tell the whole story. All told, current Federal taxes and borrowing add up to nearly 37 percent of the moderate-income family's earnings.

The table and chart on page 2 provide further details.

(COST OF CONGRESS, *from page 1*)

House and Senate will cost an additional $127.8 million.

The proposed $29 million in congressional pay hikes that made voters howl would have represented only 1.3 percent of the FY 1989 cost of Congress and Legislative Branch agencies. Tax Foundation analyts point out that Congressmens' cost hardly stops with their $89,500 current salary. They will be spending an average $100,000 each in postal expenses alone in 1989.

Congress also maintains a number of legislative agencies, such as the Congressional Budget Office, General Accounting Office, and the Architect of the Capital, each of which has its own budget. These will cost taxpayers $1.2 billion in 1989, 38 percent more than last year.

What exactly does all this money buy? Taxpayers are primarily paying for three things: Congressional leadership and administration; committees and subcommittees; and Congressional office staff.

The U.S. Office of Personnel Management reports that the Legislative Branch now employs over 37,500 workers. Congress itself has 19,200 on the payroll—7,200 in the Senate and 12,000 in the House.

Congress runs on a committee system, with 20 committees and 87 subcommittees in the Senate, employing 770 key staff personnel, and 28 committees and 160 subcommittees in the House, employing over 1,271 key staffers. Including the joint committees, the congressional bureaucracy is currently comprised of over 50 committees with over 250 subcommittees paying a key staff of over 2,100 people.

See table at left for further detail.

Outlays for the Legislative Branch of the Federal Government by Unit

Selected Fiscal Years 1970-1989*

(Thousands)

Unit	1970	1980	1988	1989
Total	$ 343,147	$ 1,217,985	$ 1,851,958	$ 2,233,439
Congress, total	179,159	581,543	993,367	1,049,816
Senate	57,585	183,890	335,235	356,570
House of Representatives	108,279	324,569	566,542	565,423
Joint activities	13,295	73,084	91,590	127,823
Legislative agencies, total	163,988	636,442	858,591	1,183,623
Architect of the Capitol	18,797	89,496	118,821	167,361
Botanic Garden	620	1,583	2,091	2,613
Congressional Budget Office	-	12,101	17,199	18,382
General Accounting Office	69,857	201,192	326,316	338,477
Government Printing Office	34,141	115,747	78,207	121,613
Library of Congress	49,804	192,740	283,235	492,235
Office of Technology Assessment	-	11,131	16,905	17,638
U.S. Tax Court	2,972	9,703	24,342	29,356
Other	-	13,675	1,973	7,040
Deductions for offsetting receipts	-12,203	-10,926	-10,498	-11,092

* Data for 1989 are estimates from the FY 1990 Budget presented in January, 1989.
Source: Office of Management and Budget

Announcing the release of

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TAX FOUNDATION'S VOL. 33, NO. 3 APRIL 1989

TAX·FEATURES

Tax Freedom Day Is May 4!

FY'89 Tax Burden Up $65 Billion; Individual Taxpayers Hit Hard, Corporations Even Harder

Federal taxes will climb 7.4 percent in the 1989 fiscal year, hitting $949.6 billion, compared with $884.4 billion in FY1988, according to Tax Foundation analysis of the projections in the President's 1990 Budget. For individual income taxpayers this represents a 6.0 percent tax increase over last year. For corporations, the news is even less pleasant. They will take a $107 billion hit, a 13.2 percent jump over fiscal 1988 levels.

Tax Burdens by State

Federal tax burdens, predictably, are heaviest in the ten most populous states:

	($Millions)		($Millions)
California	$ 121,620	Pennsylvania	$ 46,010
New York	83,634	New Jersey	43,453
Texas	58,871	Ohio	39,893
Illinois	49,609	Michigan	36,609
Florida	49,109	Massachusetts	29,422

(Continued on page 8)

Elsie M. Watters

Dr. Elsie M. Watters, former Vice President of Research for the Tax Foundation and an internationally known expert on state-local public finance and tax policy, died March 28, 1989, after a long illness. She was associated with the Foundation for 23 years prior to her retirement in 1986.

In 1988, Dr. Watters received the Governmental Research Association's Gruenberg Award, presented by GRA trustees for her "significant contribution to the governmental research effort." Before joining the Tax Foundation, she was Associate Professor in the School of Business Administration, Tulane University, New Orleans, LA, and served as an economic consultant to leading Louisiana firms.

Tax Freedom Day for 1989 falls on May 4. The Tax Foundation estimates it would take the average American 124 days—from January 1 to May 4—to satisfy all Federal, state and local tax obligations, with every cent "earned" from the beginning of the year going to the tax collectors.

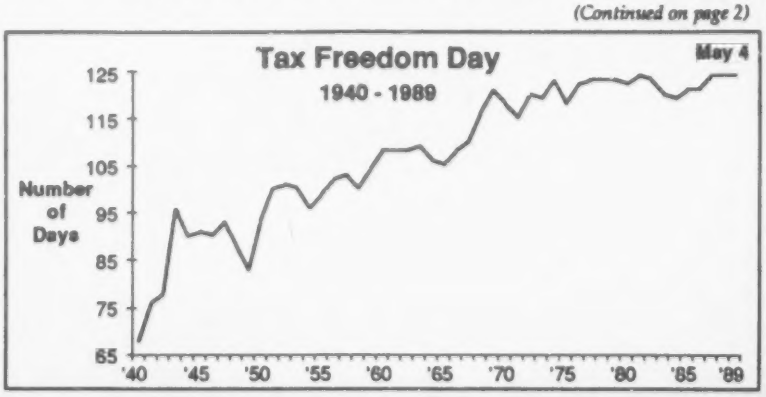
The good news is that we are no worse off than last year, when it also required 124 days to pay the tax bill. However, we finished this chore on May 3 because 1988 was a leap year. The bad news is that we are no better off relative to the overall tax burden. In fact, we are no better off than in 1981, despite strong economic growth and much ballyhooed cuts in income tax rates. This standoff can be attributed to three principal factors:

1. The base broadening provisions in the Tax Reform Act of 1986 and other legislation have subjected a greater percentage of income to taxation.
2. Social Security taxes have increased faster than the overall economy.
3. State and local taxes have continued to rise partially in reaction to reductions in Federal aid programs.

The Tax Bite and The Worker

Measuring the bite that taxes take from the typical worker's eight-hour paycheck provides another perspective on the weight of government on the private production of the nation. This year, the average worker will "labor" 2 hours 43 minutes to satisfy Federal, state and local revenue collectors. That's a minute more than last year (not

(Continued on page 2)



THIS ISSUE:

PAGE 1:
Tax Freedom Day
Federal Tax Burden
PAGE 4:
Grants-in-Aid
PAGE 5:
"Budget Watch"
PAGE 7:
"Front Burner"

(TAX FREEDOM DAY, *from page 1*)
enough to change the calendar Tax Freedom Day). The Federal government will claim 1 hour and 47 minutes worth of those wages; state-local needs will take a 56-minute chunk.

> ***"Corporations may be the conduit for paying taxes but it is the shareholders, employees, and customers who absorb the real burden."***

Tax Freedom Day and the tax bite in the 8-hour day involve some fairly simple calculations and a sweeping, though realistic, assumption. That assumption is that all taxes, including taxes on business and personal consumption, are ultimately borne by individual producers in their capacities as wage earners, proprietors and employers of capital. Corporations may be the conduit for paying taxes but it is the shareholders, employees, and customers who absorb the real burden. Sales and excise taxes are really "paid" by producers—who can be consumers too, of course. In our view, producers are best represented in an overall statistical sense by net national product. (Net National Product equals Gross National Product less capital consumption allowances. A technical paper is available which explains why NNP is preferable to GNP for this purpose.) The average "worker" in our Tax Freedom Day or tax bite calculation is a proxy for net national product and the tax burden on that worker is the ratio of total taxes to net national product—in 1989 estimated at 33.9 percent.

Our current year estimate for net national product is derived from averaging thirteen leading economic forecasts. 1989 Federal taxes are the average of projections by the Office of Management and Budget and the Congressional Budget Office, while the tax burden for states/localities is a trend extrapolation. The summary figures for 1988 and 1989 are seen in the table below.

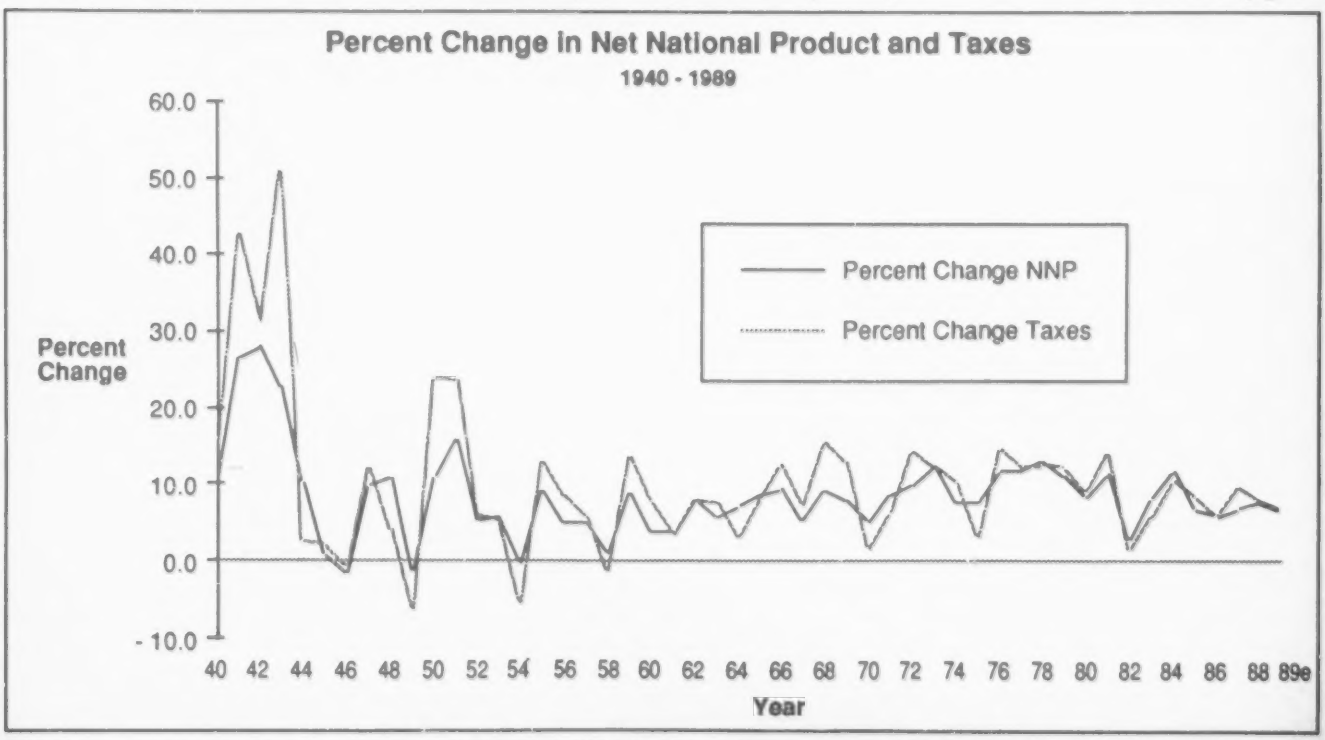
Last year Tax Freedom Day originally was projected to be May 4. Because economic growth was stronger than anticipated, the 1988 tax bite was not quite as heavy and the date slipped back one day to May 3. The history of Tax Freedom Day and the tax bite, shown in the chart on page one and the table on page three, reflect actual data for the particular year and any subsequent revisions.

As indicated by the historical data, the overall tax bite grew sharply in the 1940s and the early 1950s under wartime finance measures, then rose fairly steadily through the mid-1970s before stabilizing in the 1980s. The tax burden at the Federal level peaked in 1981. This was before tax indexing and cuts under the Economic Recovery Act of 1981 (ERTA) took effect. After 1981,

(Continued on page 3)

Year	Taxes ($Billions) Federal	State/ Local	Total	Net National Product ($Billions)	Ratio of Total Taxes/NNP
1988	$962.5	$512.1	$1,474.6	$4,357.9	33.8%
1989(e)	$1,030.1	$543.9	$1,574.0	$4,645.3	33.9%

(e) Estimates by Tax Foundation.



(TAX FREEDOM DAY, *from page 1*)

the Federal burden dipped along with recession and ERTA relief, but more recently has moved back up. The state/local tax burden peaked in 1976-1977 before Proposition #13 in California set off a round of tax limitation measure in the states. After the mid-1970s, the state/local burden dipped until 1981, then resumed its long-term rise—which is likely to continue.

"Payroll taxes .... increase steadily almost regardless of business conditions."

It should be noted that the Tax Freedom Day and tax bite calculation *does not reflect* the $160 billion Federal budget deficit. It can be argued, of course, that the average worker does have a definite "share" in this deficit and will feel its effect through the future tax burden and/or a weaker economy.

Tax Burden May Increase If Economy Falters

In past periods of economic slack, the date of Tax Freedom Day tended to retreat or at least not advance. As the economy slowed, tax receipts, particularly Federal income tax receipts, would slow even more. Also, Congress was apt to enact tax cuts to bolster lagging business activity. Although anti-recessionary fiscal policy measures sometimes had more effect when the economy was recovering, they did hold back the long-term advance in the tax burden as measured by Tax Freedom Day.

Now, however, the tax burden may be less sensitive to the business cycle and less subject to fiscal policy measures. This is shown statistically by the chart on page two comparing the percentage change in net national product and overall taxes by year since 1940. Gradually the two have come together, particularly since the late 1970s.

To cite one factor, income taxes are no longer as dominant in the overall picture. Payroll taxes, which in the Federal sector are now running close to three-quarters the size of individual and corporate income taxes combined, increase steadily almost regardless of business conditions.

More important, perhaps, with multi-billion dollar deficits persisting, Congress is not likely to respond to any economic dropoff (short of complete collapse) with more tax cuts. Any short-term economic stimulation will be left to the monetary authorities and any fiscal action which is undertaken is much more likely to involve actual tax increases. Therefore, the taxpaying public is not likely to feel any real relief in the next inevitable slowdown of the economy.

Pressures on State and Local Finances

State governments are trying to hold the line financially by pulling their belts a little tighter in 1989. Few major tax increases are anticipated. However, the 1989 growth rate in state expenditures is already outpacing the growth rate in revenues and general fund balances continue to shrink.

The dwindling reserves with which states have operated for the last few years threaten their capacity to absorb an economic slowdown without exercising tax options. New Federal mandates such as nursing home reform, welfare reform and catastrophic care will increase pressures on state spending as have cuts in Federal aid to the states. Because of constitutional or statutory requirements that operating budgets be balanced, the effect of any national economic slowdown would require the states to juggle tax increases and spending cuts. During the recession of the early 1980's, states were successful only in reducing the rate of growth in expenditures and relied more heavily on tax increases.

"The dwindling reserves with which states have operated for the last few years threaten their capacity to absorb an economic slowdown without exercising tax options."

Local government revenues are less susceptible to short-term economic fluctuation since they are primarily derived from property taxes, licenses, and user-fees. However, the fallout of reductions in Federal and state aid has intensified pressure on local governments to finance services with increased or new local tax levies. Recent trends show states more willing to allow local governments the authority to expand and implement new local option taxes.

* *

Despite the distaste of all politicians for new taxes, there are strong pressures at both Federal and state/local levels pushing in this direction. And as a weaker economy no longer necessarily means a lighter tax burden, we are likely to see Tax Freedom Day move off its recent plateau and extend further into May.

Tax Freedom Day and Tax Bite In the Eight-Hour Day

Selected Years 1929 - 1989

Year	Tax Freedom Day[a]	Tax Bite in the Eight-Hour Day[b] (Hours:Minutes) Total	Federal	State-Local
1929	February 9	:82	:19	:33
1935	March 1	1:17	:28	:49
1940	March 9[c]	1:29	:45	:44
1945	April 1	1:89	1:36	:23
1950	April 3	2:02	1:30	:32
1955	April 9	2:09	1:34	:35
1960	April 17[c]	2:22	1:40	:42
1965	April 15	2:17	1:33	:44
1970	April 28	2:34	1:40	:54
1975	April 28	2:35	1:38	:57
1980	May 1[c]	2:39	1:48	:51
1981	May 4	2:43	1:52	:51
1982	May 3	2:41	1:48	:53
1983	April 30	2:38	1:43	:55
1984	April 28[c]	2:36	1:42	:54
1985	May 1	2:38	1:44	:54
1986	May 1	2:38	1:43	:55
1987	May 4	2:42	1:47	:55
1988	May 3[c]	2:42	1:46	:56
1989e	May 4	2:43	1:47	:56

[a] "Tax Freedom Day" represents the date on which the average person would finish paying Federal, state, and local taxes if all earnings since January 1 were turned over to governments to fulfill annual tax obligations.

[b] The "Tax Bite in the Eight-Hour Day" reflects the amount of time out of each workday that the average person spends earning enough money to pay tax obligations.

[c] Leap year causes the date of Tax Freedom Day to appear one day earlier.

Source: Tax Foundation computations.

Federal Grants No Bargain for 18 States with $1.26 Average Cost for Each Dollar of Assistance

Federal Grants-In-Aid to State and Local Governments and Estimated Federal Tax Burden for Grants

Fiscal Year 1988

State	Grants[a] ($Millions)	Percent of Total Tax Burden	Estimated Tax Burden for Grants[b] ($Millions)	Tax Burden Per Dollar of Aid	
				Amount	Rank
Total	$108,724.7	100.00%	$108,724.7	$1.00	-
Alabama	1,667.9	1.22	1,324.7	.79	33
Alaska	579.8	.26	278.9	.48	50
Arizona	1,160.7	1.24	1,347.9	1.16	13
Arkansas	1,004.5	.66	719.4	.72	37
California	11,583.8	12.80	13,917.3	1.20	10
Colorado	1,199.6	1.31	1,421.7	1.19	12
Connecticut	1,542.1	2.03	2,210.4	1.43	5
Delaware	318.5	.32	342.8	1.08	16
Florida	3,415.2	5.17	5,616.8	1.64	1
Georgia	2,959.3	2.29	2,494.0	.84	30
Hawaii	477.2	.42	461.6	.97	21
Idaho	458.1	.29	310.0	.68	40
Illinois	4,669.4	5.23	5,684.5	1.22	8
Indiana	1,959.8	1.99	2,168.0	1.11	14
Iowa	1,199.2	.97	1,058.9	.88	26
Kansas	873.3	.95	1,035.7	1.19	11
Kentucky	1,750.7	1.10	1,199.3	.69	38
Louisiana	2,131.9	1.27	1,381.9	.65	43
Maine	684.7	.42	455.1	.66	39
Maryland	2,004.2	2.24	2,435.5	1.22	9
Massachusetts	3,327.6	3.10	3,368.8	1.01	18
Michigan	4,240.6	3.86	4,196.0	.99	19
Minnesota	2,117.4	1.78	1,936.4	.91	24
Mississippi	1,304.6	.63	680.1	.52	46
Missouri	1,938.1	1.96	2,130.9	1.10	15
Montana	504.5	.24	262.9	.52	47
Nebraska	711.5	.56	611.3	.86	28
Nevada	322.8	.45	490.2	1.52	2
New Hampshire	397.3	.53	576.8	1.45	4
New Jersey	3,327.5	4.58	4,979.9	1.50	3
New Mexico	726.1	.44	479.9	.66	42
New York	12,494.2	8.80	9,571.3	.77	34
North Carolina	2,296.2	2.19	2,383.8	1.04	17
North Dakota	451.3	.22	235.0	.52	48
Ohio	4,693.1	4.20	4,570.2	.97	20
Oklahoma	1,402.2	1.04	1,133.3	.81	32
Oregon	1,110.9	.98	1,064.5	.96	22
Pennsylvania	5,790.4	4.85	5,273.8	.91	25
Rhode Island	643.5	.43	469.4	.73	36
South Carolina	1,351.3	1.03	1,123.8	.83	31
South Dakota	439.5	.21	225.8	.51	49
Tennessee	2,084.4	1.64	1,779.6	.85	29
Texas	5,162.2	6.20	6,742.9	1.31	7
Utah	683.7	.46	503.4	.74	35
Vermont	323.5	.20	218.2	.67	41
Virginia	1,958.8	2.54	2,757.3	1.41	6
Washington	2,131.4	1.86	2,020.0	.95	23
West Virginia	1,054.7	.51	556.1	.53	45
Wisconsin	2,226.9	1.80	1,961.7	.88	27
Wyoming	273.8	.16	174.5	.64	44
District of Columbia	1,615.1	.35	380.8	.24	51

[a] Excludes shared revenues and payments in lieu of taxes; includes trust fund aid.
[b] The tax burden for grants is assumed to equal grant payments.

Soure: Tax Foundation computations based on data from the Treasury Department and U.S. Department of Commerce, Bureau of the Census.

There's no free lunch for residents of 18 states whose aggregate Federal tax burden to support grant programs exceeds the amount of grants received by their respective state and local governments, according to Tax Foundation analysis. The 126 million residents of the "paying" states sent Uncle Sam $59.6 billion in taxes to support grant programs, while state-local governments received back $47.5 billion in grants. This figures out to an average $1.26 "cost" per $1.00 of aid.

Looked at another way, these states shouldered over 55 percent of the cost of the $108.7 billion in Federal grants in fiscal year 1988, latest available data, and received less than 44 percent of the payout.

The 120 million residents in the other 32 states and the District of Columbia, on the others hand, paid an average 80 cents in Federal taxes for each dollar of aid received by their state-local governments—$49.1 billion in Federal taxes for $61.3 billion in Federal grants.

Tax Foundation economists emphasize that these comparisons of Federal tax burdens for aid payments per $1.00 of assistance do not actually indicate the entire costs which state and local governments incur for obtaining Federal grants. With few exceptions, states must raise additional funds to

(Continued on page 8)

Tax Features

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Budget Watch By Allen Schick

Playing Budget Games With the Savings and Loan Crisis

The Federal government is expected to spend more than $50 billion in the next two years to close or restructure hundreds of insolvent savings and loan institutions. This expenditure will be the down payment on a long-term rescue package which will probably cost taxpayers upwards of $100 billion by the time the last bills are paid, in the year 2002 or later. However, instead of adding to the deficit, the S&L plan devised by the Administration and currently under consideration in Congress would cause a $9 billion drop in total spending and the deficit for the 1990 fiscal year.

The budgetary alchemy of turning a huge spending increase into a sizeable deficit reduction has a lot to do with the financial problems facing the Federal government and the nation. Because the government's financial commitment is open-ended, the full cost of the S&L bailout will not be known until the 30-year bonds Washington wants to have floated are paid off. Whatever the cost, however, one can be sure that the taxpayers will pick up most of the tab. One should not be surprised if the optimistic cost estimates used in putting together the S&L package prove to be wide of the mark.

"The budgetary alchemy of turning a huge spending increase into a sizeable deficit reduction has a lot to do with the financial problems facing the Federal government and the nation."

Magic of Off-Budget Financing

The key steps in converting a spending increase into a lower deficit are to establish a corporation, authorize it to borrow vast sums of money, provide that the borrowed funds are not to be included in the Budget, and commit the Treasury to stand behind this new debt. This formula was used in 1987 to establish the Financing Corporation (FICO) and authorize it to borrow $10.8 for the Federal Savings and Loan Insurance Corporation (FSLIC), the Federal agency with direct responsibility for thrift institutions. This amount has proven to be much less than is needed, so the new plan calls for borrowing on a much larger scale by a new corporation.

A new Resolution Financing Corporation (REFCORP) would be authorized to borrow $50 billion. The principal on this debt would be covered by long-term zero coupon Treasuries which REFCORP would purchase at an estimated cost of $6 billion, but which would be worth $50 billion at maturity. Part of the interest on the REFCORP debt would be paid by the S&L industry or from the proceeds of liquidated assets. Most, however, would be paid by the Federal government.

"The key steps in converting a spending increase into a lower deficit are to establish a corporation, authorize it to borrow vast sums of money, provide that the borrowed funds are not to be included in the Budget, and commit the Treasury to stand behind this new debt."

Although REFCORP would be established by the Federal government, it would be classified as a private corporation and the funds borrowed would not appear in the budget.

This would not be the end of the story, however. Strangely, the $50 billion borrowed by REFCORP would be recorded in the budget as a reduction in total outlays and, therefore, in the deficit as well. This would happen because REFCORP would be required to promptly turn over the full proceeds of any bonds floated by it to either FSLIC or another new corporation, the Resolution Trust Corporation (RTC), which would be responsible for disposing of insolvent thrift institutions. Unlike REFCORP, RTC would be classified as a government agency; hence, the $50 billion turned over to it and FSLIC would be counted in the budget as an "offsetting collection," a type of receipt which has the effect of reducing budget outlays.

Table 1 on page 6 shows how the flow of funds into and out of REFCORP and other transactions would affect the *budgeted* cost of the S&L crisis. The data cover the 1989-99 decade, but because of recourse to long-term debt, the government will continue to bear heavy financial responsibilities until the REFCORP bonds are retired in the next century. It is also important to keep in mind that these estimates are highly uncertain. In the several months since the Administration plan was unveiled in February 1989, they have been revised several times. Additional adjustments can be expected as conditions change.

The first thing to notice about this table is the dramatic difference between the top line which shows the funds disbursed by Federal agencies (FSLIC/RTC) and the last line which shows the impact on the budget. In both fiscal 1990 and 1991, FSLIC and the new RTC are expected to be active in resolving failed thrifts. Their combined expenditures are projected to be

(Continued on page 6)

(BUDGET WATCH, *from page 5*)

almost $60 billion in these two years, mostly to close or restructure troubled institutions. The *budgeted* outlays of FSLIC/RTC, on the other hand, are projected to be only about one-sixth of this amount, *barely $10 billion*. The difference between the actual and budgeted expenditures is due to the reflow of funds from REFCORP and other sources. Table 2 shows much higher budgeted outlays if the FSLIC bailout were fully included in the budget.

Table 1
Off-budget Treatment of S&L Rescue Proposal
(fiscal years; in billions of dollars)

	1989	1990	1991	1992	1993	1994	1989-1994	1989-1999
FSLIC/RTC Disbursements	27.7	31.7	24.3	10.4	11.0	8.2	113.2	138.2
REFCORP Payments on FSLIC/RTC	-10.0	-25.0	-15.0	0.0	0.0	0.0	-50.0	-50.0
FICO Bonds	-3.8	-3.3	0.0	0.0	0.0	0.0	-7.1	-7.1
Other Collections	-3.2	-2.0	-3.3	-5.8	-6.3	-5.9	-33.5	-50.3
Treasury Payment of REFCORP Interest	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0
Total Budgeted Outlays	11.1	2.8	7.6	5.5	5.5	3.4	36.0	59.9

Sources: Office of Management and Budget and Congressional Budget Office

Table 1 also reveals how the bailout has been structured to impact on different fiscal years. The current fiscal year (1989) is estimated to have net budgeted outlays of about $11 billion. This sizeable expenditure will add to the deficit, but because it was incurred (for the most part) after the Gramm-Rudman-Hollings (GRH) projections were made, it will not result in a sequestration of funds. The next fiscal year (1990) is a different story, however. Any additional outlays will increase the likelihood of a GRH sequester later this year unless they are offset by "offsetting collections" such as the REFCORP money. It is not accidental that the S&L rescue has been scheduled to contribute to deficit reduction in 1990.

It is projected that REFCORP will borrow the full $50 billion and remit it to FSLIC/RTC during a 3-year period 1989-1991. Fortuitously, the Administration expects that most insolvent S&Ls will have been liquidated by the time that offsetting money from REFCORP ceases. Hence, the annual burden on future budgets should be fairly manageable. Indeed, the REFCORP device not only removes much of the cost from the 1989-1991 budgets, it also spread the cost over a 30-year period. In so doing, it changes the character of that cost from the direct expenditure of assisting failing institutions to the annual expenses of servicing the REFCORP debt. The Administration has estimated that the Treasury will have to pay $6 billion in interest on the REFCORP debt in the 1989-94 period, but more than $80 billion in later years. Into the next century, REFCORP interest obligations will be an annual "uncontrollable" expenditure of $3-5 billion.

Table 2
Alternative On-budget Treatment of S&L Rescue Proposal
(fiscal years; in billions of dollars)

	1989	1990	1991	1992	1993	1994	1989-1994	1989-1999
FSLIC/RTC Disbursements	27.7	31.7	24.3	10.7	11.3	8.5	114.2	140.6
FSLIC/RTC Collections	-7.8	-8.1	-5.8	-6.1	-6.6	-6.2	-40.6	-58.8
Treasury Payments For REFCORP	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0
Total Budgeted Outlays	20.4	25.0	20.1	5.5	5.5	3.4	79.9	103.8

Sources: Office of Management and Budget and Congressional Budget Office

How Should the Budget Deal With the S&L Rescue?

What is the most reasonable way of budgeting for the Federal government's share of the cost of the S&L bailout? The issue is not how much should be spent—that will largely be determined by the extent to which the liabilities of troubled institutions exceed their assets. Two key issues merit attention. (1) Should the government absorb the full cost in the next few years, or should it spread the cost over a 30-year period? (2) Should the near-term costs be removed from the budget through REFCORP financing, or should they be treated as on-budget expenditures?

A consensus appears to have formed around the first issue, but not around the second. Issuing 30-year bonds to pay for expenses that have already been incurred or will be incurred in the next few years will add considerably to interest charges. Indeed, when the dust finally settles on the S&L crisis, these charges are likely to constitute the single largest expense to Federal taxpayers. Nevertheless, the very size of the crisis dictates a long-term solution. The only viable substitutes for bond financing would be to raise an equivalent amount in taxes or make a similar cut in expenditures. Either course of action might have a destabilizing effect on the economy, and both would relieve the S&L industry from their continuing responsibility for the crisis. True, the industry is not presently sturdy enough to bear more than a small part of the total financial exposure, but loading the full cost on current budgets would remove even that obligation.

The second issue—on- or off-budget financing—has split the Ad-

(Continued on page 7)

(BUDGET WATCH, *from page 6*)

ministration and the Congressional Budget Office. The huge difference between the two approaches emerges from a comparison of the top and bottom parts of the table accompanying this article. The year ahead—fiscal 1990—is particularly illuminating. While off-budget financing would leave net outlays of only $2.8 billion, putting the rescue on budget would cause outlays to balloon to $25 billion. Adding $25 billion to the fiscal 1990 deficit would almost certainly put that year's GRH deficit target beyond reach. CBO has estimated that the off-budget issuance of REFCORP bonds would add $100-$200 million a year in interest payments compared to direct financing by the Treasury.

It appear that the sole reason for removing REFCORP from the budget is to show lower outlays than would actually be incurred. The key test for determining whether a corporation should be on- or off-budget is whether it is privately owned. REFCORP does not satisfy the private ownership test. The $50 billion borrowed by REFCORP would carry an explicit government guarantee of interest and an implicit guarantee of the principal. REFCORP's sole purpose would be to raise funds for the government. Its actions and policies would be controlled by a Federal agency. It could not pay any dividends, nor would it ever by likely to have a positive net worth. Finally, REFCORP would have a quasi-governmental power, that of levying and collecting assessments on Federally insured thrifts.

Both the Comptroller General and the Director of the Congressional Budget Office have proposed that the S&L transactions be included in the budget. The latter has also suggested that the cost of closing ailing S&Ls be excluded from the GRH deficit computations on the ground that these payments would not create new liabilities. Rather, they would exchange one liability—the obligations already incurred by FSLIC to insure the deposits of thrift institutions—for another liability—the cost of the bailout. "Excluding spending from the Balanced Budget (GRH) Act," the CBO Director argued, "may set unfortunate precedents, but so does creating off-budget entities to perform government functions."

Everything about the S&L crisis is big: the money lost and assets wasted, the cost to public taxpayers and to private investors. No matter how it is structured, the rescue will cost many tens of billions of dollars. It would be unfortunate if the most enduring lesson would be how to make tens of billions of dollars disappear from the budget without leaving a single trace except the big hole in the taxpayer's purse and the further blow to the credibility of government.

THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

"Status Quo Is Not Enough"

Tax Freedom Day 1989 is May 4. The average taxpayer will spend 124 days earning the money to pay the tax bill of Federal, state and local government — same as last year, same as the year before, and same as 1981. Some will argue, "Marvelous, we have held the line. The tax writers have made no new incursions into the pockets of our fellow Americans."

That a situation has not worsened may be acceptable in medicine, where the primary rule of treament is "First, do no harm." However, even in medicine, the ultimate goal is to improve the patient's condition, not maintain the status quo.

In tax policy, too, there are grounds for questioning whether the present tax load on the national economy is acceptable simply because it hasn't gotten worse. We had a huge tax cut at the beginning of this decade. We had a much-vaunted commitment to balance the deficit and hold the lid on spending in the Gramm-Rudman-Holllings deficit reduction measure. We had what was supposed to be the first major tax overhaul in a generation with the Tax Reform Act of 1986. Yet, we are no better off than we were eight years ago. Apparently, as the Queen of Hearts told Alice, "It takes all the running you can do, to keep in the same place."

At the Federal level, a significant portion of the individual income tax rate cuts have been paid for by shifting the burden to the corporate sector, by devising a panoply of "non-tax taxes," by returning to states and localities responsibility for funding many programs once covered by Federal grants (resulting in higher state taxes). By creating quasi-governmental agencies Uncle Sam has used credit to mask debt. By mandating benefits for which government gets the applause and employers get the bill, the Congress has managed to have the best of both worlds — gain with no (perceived) pain.

We are in the longest peace-time expansion in history. This automatically increases the net take of the tax collector, and that take now equals 33.9% of Net National Product. Yet, the deficit proves intractable, a clamor is made for more taxes, and everyone seems to have a pet program to be begun or expanded at taxpayers' expense.

So this Tax Freedom Day, rather than rejoice that we have finally begun earning for ourselves, maybe we should examine the fact that, like the mad Queen, we are merely running in place when it comes to making government more cost effective.

One would hope that fiscal policy could find a better role model than *Alice in Wonderland*.

(GRANTS-IN-AID, *from page 4*)

administer the programs for which aid is granted and and must also allocate matching funds to qualify as recipients. Foundation researchers estimate that state and local jurisdictions must provide about 42 cents of matching funds for each $1.00 of Federal aid coming to them.

These tax burdens are estimated by the Tax Foundation, using a formula that measures the final geographic burden of taxes, as distinguished from the area of initial impact.

In the grant "sweepstakes," Foundation calculations list the following as the top ten "paying" states:

Rank and State	Tax Burden Per $1 of Aid
1) Florida	$1.64
2) Nevada	1.52
3) New Jersey	1.50
4) New Hampshire	1.45
5) Connecticut	1.43
6) Virginia	1.41
7) Texas	1.31
8) Illinois	1.22
9) Maryland	1.22
10) California	1.20

The ten lowest "payors" were:

51) District of Columbia	.24
50) Alaska	.48
49) South Dakota	.51
48) North Dakota	.52
47) Montana	.52
46) Mississippi	.52
45) West Virginia	.53
44) Wyoming	.64
43) Louisiana	.65
42) New Mexico	.66

The table on page two gives total and per capita tax burdens per dollar of Federal aid by state, for fiscal year 1988, latest data available.

(TAX BURDEN, *from page 1*)

These "big ten" states will send Uncle Sam $588.2 billion in FY89, 62 percent of all Federal taxes.

At the lower end of the scale, tax burdens will be lightest on the following nine states, plus the District of Columbia:

	($Millions)		($Millions)
Maine	$ 3,975	Montana	$ 2,299
D.C.	3,323	N. Dakota	2,051
Delaware	2,996	S. Dakota	1,978
Idaho	2,707	Vermont	1,903
Alaska	2,430	Wyoming	1,523

These bottom 10 states will pay only 2.7 percent of the total Federal tax burden, a total of $25.2 billion.

Per Capita Tax Burdens

When total Federal taxes paid are ranked according to the per capita burden in a given state, Tax Foundation researchers note an average increase of $227 over 1988 amounts. On average, the national per capita Federal tax burden will hit $3,825 in FY89. Per person, the largest burden is carried in these nine states and the District of Columbia:

Connecticut	$ 5,959	Maryland	$ 4,606
New Jersey	5,603	New Hampshire	4,594
D.C.	5,386	Delaware	4,553
Massachusetts	4,999	Alaska	4,301
New York	4,675	Illinois	4,270

The average Federal tax burden per capita for citizens in the top ten states is $4,532. Lowest burdens, an average of $2,535, are borne by taxpayers in the following ten states:

Kentucky	$ 2,798	Idaho	$ 2,673
S. Carolina	2,796	Arkansas	2,623
S. Dakota	2,771	West Virginia	2,577
Louisiana	2,705	Utah	2,521
New Mexico	2,691	Mississippi	2,241

Tax Foundation researchers point out that citizens in the top ten states will pay an average per capita tax burden that is $2,254 higher than citizens in the lowest per capita states. See table on page 4 for further detail.

Note: "Memorandum on the Allocation of the Federal Tax Burden by State, Fiscal Years 1988–90," and "Federal Tax Burdens in States and Metropolitan Areas," which provide a 10-year tax burden history and explain the methodology of the study, are each available from the Tax Foundation for $4 + $1 p/h.

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TAX FOUNDATION'S VOL. 33, NO. 4 MAY/JUNE 1989

TAX·FEATURES

What Brackets Shoulder the U.S. Income Tax Burden? Top Half Pays Over 90 Percent; Top Ten Percent Pays Over Half

The top earning half of the population continues to pay well over 90 percent of the Federal individual income tax bill, according to Tax Foundation analysis of preliminary IRS data for 1987 — the first comprehensive income tax data reflecting the effects of the Tax Reform Act of 1986 (TRA'86). Despite all the major tax legislation of the past decade, this group's share of the tax load has varied within a narrow 1.5 percent range — from a low of 92.6 percent in 1982 to a high of 94.1 percent for 1987.

The system remains progressive as the top ten percent of earners continue to shoulder a significantly larger share of the tax burden, up almost six percentage points, from 49.5 percent in 1979 to 55.4 percent in 1987. This growth in tax burden has occurred despite the alleged upper-income bias of the rate reductions and other tax cuts under the Economic Recovery Tax Act of 1981 (ERTA), and more recently the Tax Reform Act of 1986.

Growth in the income base itself has been increasing faster at the upper end of the income scale, resulting in increased income tax receipts from top earners. The 107 million returns filed for tax year 1987 reported an increase in adjusted gross income of about $300 billion, largely due to the fact that a number of income exclusions and adjustments were either repealed or limited by the new law. However, taxpayers reported receiving larger amounts of certain types of income, especially pension and annuity income. Over five million fewer returns showed itemized deductions. This was primarily due to the increase in the amount of the standard deduction all taxpayers can claim and a reduction in the deductions allowed, especially the elimination of the deduction for sales taxes.

At the bottom line, 1987 total income tax receipts reached $371 billion, a modest one percent or $4 billion increase over 1986 collections. How-

(See TAX BURDEN on page 2)

Federal Income Taxes Paid by High and Low-Income Taxpayers
1979 and 1987[a]

	Percent of Tax Paid	
Income Rank	1979	1987[a]
Highest 5%	37.6	43.0
Highest 10%	49.5	55.4
Highest 25%	73.1	76.7
Highest 50%	93.2	94.1
Lowest 50%	6.8	5.9
Lowest 25%	0.5	0.7

[a] Data for 1987 are preliminary.

Washington's Largest Monument: $3.12 Trillion Debt Seen For FY'90

The present national debt ceiling of $2.8 trillion, set by Congress in 1987, will inevitably be breached before the current fiscal year ends September 30. Legislation increasing the debt limit must be enacted to insure the Treasury does not default on its maturing debt and payment obligations. To add insult to injury, hints of using this must-pass legislation to attach a significant tax increase are already surfacing.

Congressional Budget Office estimates now anticipate the FY1990 debt reaching a whopping $3.12 trillion. That represents well over $12,000 for every man, woman, and child in the United States; triple the amount of just ten years ago. Over the last decade, the upward climb in the Federal debt has been unremitting. Outstanding debt of the U.S. government passed $500 billion in 1975. By 1982, it had doubled, topping the $1 trillion level for the first time. In just four more years, it doubled again, exceeding $2 trillion in 1986. By 1990 debt will increase another trillion to over $3.12 trillion. How did we get into this mushrooming debt situation? Do deficits and the size of the debt really matter?

Budget Process Damaging

For many years now the White House and Congress have generally been locked in a budgetary stalemate which has impeded any significant deficit reductions. Little has been done to control the persistent escalating costs of entitlement programs. The FY1989 budget deficit is estimated at over $160 billion — no less than what it has averaged over the past eight years — each year's deficit fueling the larger accumulated debt total. The Gramm-Rudman-Hollings (GRH) process has helped some, but far less than promised. When GRH was first enacted during fiscal year 1986, the mandated deficit path reached balance in 1991. Two years later, the deficit was

(See DEBT CEILING on page 3)

THIS ISSUE:

PAGE 1:
Federal Income Tax Burden
New Debt Ceiling
PAGE 4:
"Budget Watch"
PAGE 7:
State Taxes
"Front Burner"
INSERT:
Principles of Taxation

(TAX BURDEN from page 1)

ever, the average amount of income tax paid per taxpayer declined from $4,374 to $4,280. Although 1987 total receipts increased by $4 billion, the income tax distribution reveals that those earning $50,000 or more paid $24 billion more in income tax in 1987 while the under $50,000 income groups experienced a tax reduction of $20 billion.

In 1987, the top five percent of earners paid an average tax of $29,820, up 71 percent from 1979. The top 10 percent paid $19,214, a 68 percent increase over what they paid in 1979. While the top ten percent, or 10.7 million earners, paid well over half the total income tax in 1987, their adjusted gross income ranged down to $54,700, not exactly "fat cat" status. It still takes millions of basically middle and upper-middle income taxpayers to pay the bulk of the total income tax bill.

Federal Income Taxes Paid by High and Low-Income Taxpayers, 1979 and 1987[a]

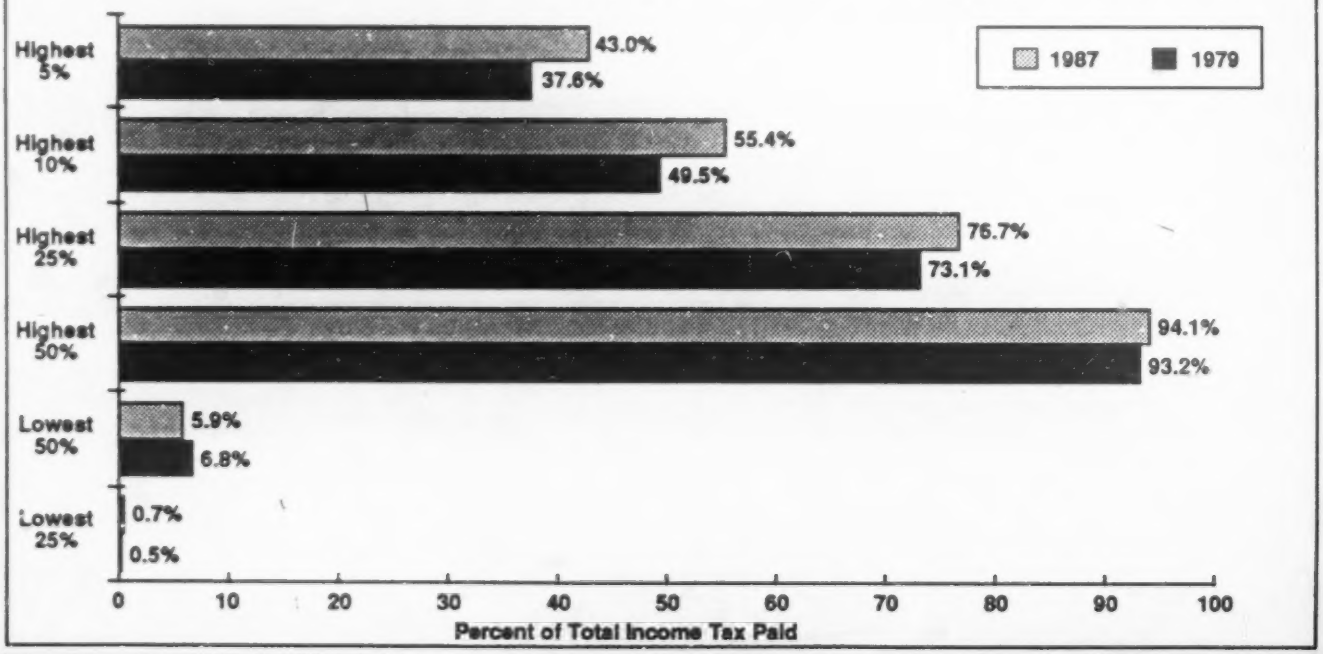
Adjusted Gross Income Class	Income Level		Percent of Tax Paid		Average Tax	
	1979	1987	1979	1987	1979	1987
Highest 5%	$ 39,000 or more	$ 71,125 or more	37.6%	43.0%	$ 17,407	$ 29,820
Highest 10%	32,710 or more	54,700 or more	49.5	55.4	11,456	19,214
Highest 25%	21,760 or more	34,260 or more	73.1	76.7	6,769	10,643
Highest 50%	11,870 or more	17,598 or more	93.2	94.1	4,315	6,526
Lowest 50%	11,869 or less	17,597 or less	6.8	5.9	313	410
Lowest 25%	5,565 or less	7,800 or less	0.5	0.7	46	90
Lowest 10%	2,212 or less	2,880 or less	[b]	[b]	9	25

1987 Income and Tax Data

Adjusted Gross Income Class	Total Individual Returns (thousands)	Total Adjusted Gross Income ($billions)	Percentage of Adjusted Gross Income	Average Tax Rate
Highest 5%	5,353	$ 713.4	25.6%	22.4%
Highest 10%	10,705	1,032.5	37.0	19.9
Highest 25%	26,763	1,705.4	61.2	16.7
Highest 50%	53,526	2,383.6	85.5	14.7
Lowest 50%	53,526	404.5	14.5	5.4
Lowest 25%	26,763	73.0	2.6	3.3
Lowest 10%	10,705	-13.1	—	—

[a] Data for 1987 are preliminary.
[b] Less than .07 percent.
Source: Tax Foundation computations based on Statistics of Income, Internal Revenue Service, U.S. Department of the Treasury.

Percent of Federal Income Taxes Paid by High and Low-Income Taxpayers, 1979 and 1987[a]



(DEBT CEILING from page 1)

far above the mandated path. Congress and the President simply revised the law so that balance would be reached in 1993. Both branches have since used accounting tricks to make the deficit appear lower than it actually is. Although annual deficits have decreased on paper over the last several years, the debt has been increasing by over $250 billion each year during the same period.

Debt Burden

Net interest payments (interest paid by the government less interest received on debt held by Federal accounts) is estimated to reach $170 billion in FY1990 — representing a record 15 percent of total outlays. Since 1980, interest costs have been the fastest growing segment of the Federal budget. In 1989 alone, interest payments will represent over $1,800 per U.S. household. More than one out of every seven dollars in the budget will be spent to pay interest on the public debt. Interest on the debt has generally risen much faster than the debt itself due to a strong upward trend in interest rates that must be paid on new borrowing and refunded debt.

Foreign residents are holding increasing amounts of the public debt, as we have had increasing difficulty financing the debt with our own savings — evident in the historically low U.S. savings rate.

Do Deficits and the Size of the Debt Really Matter?

More and more talk is being heard these days downplaying the impact the present Federal deficit and associated debt has on the overall economy. Whether this notion is correct depends on sorting fact from fiction.

FICTION: The deficit has grown ever larger compared to the economy.

FACT: The deficit has been declining as a percentage of GNP — from a recent peak of 6.3 percent in FY1983 to an estimated 1.8 percent by FY1990.

FICTION: With an expanding economy, deficit reduction is not vital.

FACT: The economy is in its seventh year of economic expansion, but it is a safe bet this expansion will come to an end. If the economy slows while the deficit is still large, government's recession-fighting options will be severely limited.

FICTION: The current debt burden is the largest ever.

FACT: As a percentage of GNP the Federal debt has been much higher, generally during wartime or recession. However, the current debt burden is much higher than during any peacetime period when unemployment was as low as it is now.

FICTION: The debt doesn't matter because we owe it to ourselves.

FACT: While approximately 84 percent of the public debt is currently held by U.S. interests, an increasing amount is being absorbed by foreign residents. Interest paid to foreign residents represents the transfer of wealth from the U.S. to other countries. Furthermore, the government has become increasingly dependent on the willingness of foreigners to lend us money, thus putting upward pressure on interest rates.

FICTION: We should eliminate the deficit as quickly as possible.

FACT: Cutting the deficit too quickly could do more harm than good. Eliminating the deficit through severe spending cuts and/or tax increases in a short period might cause more fiscal drag than the economy can stand.

The tables above and below provide further details.

Trends in Foreign Holdings of Federal Debt

Selected Fiscal Years 1965-1988
($Billions)

	Debt Held by the Public			Interest on Debt Held by the Public		
Year	Total	Foreign	Percent Foreign	Total	Foreign	Percent Foreign
1965	$260.8	$12.3	4.7%	$9.8	$0.5	5.1%
1970	283.2	14.0	4.9	15.6	0.8	5.1
1975	394.7	66.0	16.7	24.7	4.5	18.2
1980	709.3	121.7	17.2	60.4	12.0	19.9
1981	784.8	130.7	16.7	78.9	16.1	20.4
1982	919.2	140.6	15.3	97.7	17.9	18.3
1983	1,131.0	160.1	14.2	107.7	18.0	16.7
1984	1,300.0	175.5	13.5	129.0	19.0	14.7
1985	1,499.4	209.8	14.0	148.2	21.2	14.3
1986	1,736.2	253.4	14.6	155.4	22.3	14.4
1987	1,888.1	267.0	14.1	157.5	23.6	15.0
1988	2,050.2	334.3	16.3	169.8	27.3	16.1

Source: Treasury Department; Department of Commerce, Bureau of Economic Analysis; and Tax Foundation computations.

Trends in Federal Debt, Deficits, and Related Measures

Selected Fiscal Years 1940-1990
($Billions Except Per Capita)

	Debt Outstanding[a]			Net Interest				Deficit	
Year	Total	Per Capita	% of GNP	Total	Per Capita	% of Outlays	% of GNP	Total	% of GNP
1940	$50.7	$381	52.9%	$0.9	$7	9.5%	0.9%	-$2.9	-3.0%
1945	260.1	1,856	122.5	3.9	28	3.4	1.5	-47.6	-22.4
1950	256.9	1,687	96.3	4.8	32	11.3	1.8	-3.1	-1.2
1955	274.4	1,654	71.0	4.9	30	7.1	1.3	-3.0	-0.8
1960	290.5	1,608	57.3	6.9	38	7.5	1.4		
1965	322.3	1,658	47.9	8.8	44	7.3	1.3	-1.4	-0.2
1970	380.9	1,858	38.5	14.4	70	7.4	1.5	-2.8	-0.3
1975	541.9	2,509	35.6	23.2	107	7.0	1.5	-53.2	-3.5
1980	908.5	3,999	34.0	52.5	231	8.9	2.0	-73.8	-2.8
1981	994 3	4,320	33.3	68.7	299	10.1	2.3	-78.8	-2.6
1982	1,136.8	4,889	36.2	85.0	366	11.4	2.7	-127.9	-4.1
1983	1,371.2	5,840	41.3	89.8	382	11.1	2.7	-207.8	-6.3
1984	1,564.1	6,600	42.4	111.1	469	13.0	3.0	-185.3	-5.0
1985	1,817.0	7,594	46.0	129.4	541	13.7	3.3	-212.3	-5.4
1986	2,120.1	8,775	50.6	136.0	563	13.7	3.2	-221.2	-5.3
1987	2,345.6	9,616	52.9	138.6	568	13.8	3.1	-149.7	-3.4
1988	2,600.8	10,568	54.4	151.7	616	14.3	3.2	-155.1	-3.2
1989[b]	2,858.4	11,514	56.0	165.7	667	14.6	3.2	-161.5	-3.2
1990[b]	3,122.8	12,471	56.7	170.1	679	14.8	3.2	-99.7	-1.8

[a] End of fiscal year.
[b] Estimates based on projections from Office of Management and Budget; Congressional Budget Office; and House Budget Committee.
Source: Treasury Department; Office of Management and Budget; House Budget Committee; and Tax Foundation computations.

(See BUDGET WATCH on page 5)

Budget Watch By Allen Schick

Half a Trillion More . . . . And Still Not Enough

President Bush has called for a return to the old ways of preparing the Federal budget. Instead of beginning with baseline projections which adjust the future cost of current programs for inflation and mandatory workload changes, the President has urged that budgeting begin with an estimate of the additional revenue expected for the next year. The government would then decide how to spend this increment. It could allocate a portion to reducing the deficit and part to program needs. This approach, Bush has suggested, would enable the government to bring the budget back into balance while providing for new priorities.

"Federal receipts soared from $400 billion in 1978 to more than $900 billion in 1988 . . . Anyone who says that the government has not done a good job producing revenue just hasn't looked at the facts."

With this approach in mind, let us flash back to the late 1970s when the Federal budget was less than half its current size and examine how incremental revenue has been spent during the past decade. The most surprising trend is the truly prodigious rise in Federal revenue during the 1978-1988 period. Federal receipts soared from $400 billion in 1978 to more than $900 billion in 1988, the last complete fiscal year. Anyone who says that the government has not done a good job producing revenue just hasn't looked at the facts.

Now, let us see what all that money bought. Suppose that a decade ago, the government had known that it would have half a trillion dollars of additional money, and that it therefore decided to make liquidation of the deficit, then hovering around $60 billion, its number one budget objective. No one in his right mind could have envisioned that this steep increase in revenue would be accompanied by a huge run-up in the deficit. Of course, with the benefit of hindsight, we know that that was exactly what happened. During a decade in which receipts doubled, the budget deficit almost tripled.

How did the Federal government manage to overspend its $500 billion revenue dividend? A key part of the answer is that the money was not spent in one fell swoop. A portion was parcelled out each year, so that the budget never dealt with the issue of what half a trillion dollars might accomplish. Budgeting settled for a comfortable incrementalism in which the only thing that mattered was paying the next year's incremental claims.

The additional funds were distributed among a large number of Federal programs. A few programs were terminated during the decade, revenue sharing and urban development block grants (UD-AGS) being the most notable, but most spent more in 1988 than they did 10 years earlier. However, looking at the array of Federal programs leaves out a startling characteristic of the escalation in Federal spending. During the past decade, more than 95 percent of the incremental revenues were consumed by only four spending categories: national defense, Social Security, interest payments, and Medicare. The remainder was spread among other entitlement programs and nondefense discretionary outlays. Because the remainder was not enough to pay for everything else, the government spent an additional $100 billion that it didn't take in, thus producing bulging budget deficits in the 1980s.

"During a decade in which receipts doubled, the budget deficit almost tripled."

The following paragraphs review each of the major spending categories to see how we got into the budget mess and what might ensue in the years ahead.

National Defense

This is the most volatile portion of the budget; hence, the past is an uncertain guide to the future. We know that defense goes through cycles of buildup and attrition, but we do not know in advance how long and deep each leg of the cycle will be. In the late 1970s, the government decided to reverse the prolonged decline in defense spending that occurred after

Revenue and Outlay Increases
Fiscal Years 1978-1988
(dollars in billions)

	1978	1988	Difference	Outlay Increase as Percent of Revenue Increase
Total Revenue	$400	$909	$509	—
Total Outlays	459	1,064	605	—
National Defense	105	290	185	36%
Social Security	92	217	125	25%
Net Interest	35	152	117	23%
Medicare	25	86	61	12%
Other Mandatory Spending	101	198	97	19%
Nondefense Discretionary Outlays	124	176	72	14%
Budget Deficit	59	155	96	—

Source: Congressional Budget Office

the Vietnam War. The buildup phase started while Carter was still President, accelerated when Reagan took office, peaked in the mid-1980s, and has ground to a halt since then. Defense outlays are continuing to rise gradually, principally because of obligations incurred during the buildup phase. Unless there is a severe deterioration in the international situation, defense will not be a leading source of spending increases in the 1990s. Its share of the Federal budget is likely to drop below the level it was when Reagan became President.

Social Security

There is nothing cyclical about the progressive rise in Social Security expenditures. They go up year after year, propelled by the growth in the elderly population (about half a million Americans are added to the Social Security rolls each year) and by the automatic adjustment of benefits for inflation. Because Social Security receipts are going up faster than outlays, if is hard to get politicians to even consider cutbacks in this area. By the mid-1990s, the balance in the Social Security funds will be about $100 billion. The money is supposed to be saved to pay benefits in the next century when the postwar baby boom generation retires. In fact, it is being borrowed to finance other portions of the budget. Without Social Security, the budget deficit would be approximately $250 billion and rising.

"Unless there is a severe deterioration in the international situation, defense will not be a leading source of spending increase in the 1990s."

Net Interest

The rise in interest payments illustrates how one year's deficit begets larger deficits in the future. The Federal government spent $117 billion more on these payments in 1988 than it did a decade earlier. In fact, the spiralling interest charges have accounted for the entire rise in the budget deficit during this period. To put the matter simply, if interest payments were no higher than they were in the late 1970s, today's deficit would be smaller than it was then. The future trend in interest charges depend on whether the government reins in the deficit. If it doesn't, a rising share of the budget will go for interest.

Medicare

The past decade offers a bleak outlook for the 1990s. During the 1980s, Medicare has been (a) the fastest growing Federal program, and (b) according to official statistics, the program that has suffered the most cutbacks. Medicare spending tripled during the past decade, a period during which $50 billion were allegedly lopped from this program. Some cuts have been made, but the official figures have been blown up by an assortment of gimmicks such as shifting the payments of funds from one year to the next. The steep rise in Medicare outlays has been driven by high inflation in health care, the aging of the population, the introduction of expensive technology, and increased utilization of services. CBO has projected that these factors will add another $100 billion in Medicare outlays by the 1994 fiscal year. If nothing is done to control costs, Medicare will consume a rising share of incremental revenue.

Other Mandatory Outlays

With the exception of defense, mandatory programs were the engine of spending growth in the 1978-88 period. In addition to the three big categories discussed above (Social Security, interest, and Medicare) the government operates dozens of other entitlements with an aggregate cost in excess of $200 billion a year. These include military and civilian retirement, Medicaid, food stamps, farm price supports, and veterans benefits. One should expect the spending growth in these programs to be at least as high in the next decade as in the previous one. Less than one-fifth of entitlement outlays are targeted to needy persons. One way of slowing the spiral in entitlements would be to narrow the eligibility rules, but this would likely be a politically difficult move.

Nondefense Discretionary Outlays

Discretionary spending increased during the past decade, but at a much slower rate than any other major category of expenditure. Although they now account for barely 15 percent of total outlays, discretionary programs still add up to more than $175 billion a year. Their share of future budgets might depend on how the "guns versus butter" competition for Federal dollars fares, as well as on the President's success in holding the line on tax increases. For discretionary spending to accelerate, it will be necessary to take funds from defense or from taxpayers. One should not be surprised if cutbacks in defense translate into higher domestic expenditure, not a lower deficit. Similarly, a tax increase might do more to ease pressure on domestic programs than to curtail the deficit.

"For discretionary spending to accelerate, it will be necessary to take funds from defense or from taxpayers."

There is a real possibility that the next decade will be a replay of the previous one, at least insofar as overspending incremental revenue is concerned. A decade from now, the Federal government will be taking in an extra one trillion dollars a year. Unless its spending habits change, Uncle Sam might find that one trillion dollars more is not enough. Like the overeaters in the Alka-Seltzer ads, the overspenders in the Federal budget commiserate, "We can't believe we spent the whole thing." They have, and more. Sooner or later, it will be necessary for the government to take the strong medicine of spending control. If it doesn't, one trillion dollars will disappear just as quickly as half a trillion did.

Major State Taxes and Rates

as of July 1, 1989

State	Income Taxes: Corporate	Income Taxes: Individual	General Sales and Use Tax	Gasoline Tax (per gallon)	Cigarette Tax (per pack of 20)	Property Tax
Alabama	5% (F)	2 to 5% (F)	4% (a)	11 cents	16.5 cents	X
Arizona	2.5 to 10.5 (F)	2 to 8 (F)	5 (a)	17	15	X
Arkansas	1 to 6	1 to 7	4 (a)	13.5	21	X
California	9.3 (q)	1 to 9.3 (q)	4.75 (a)	9	35	X
Colorado	5 to 5.4 (b)	5 (q)	3 (a)	12	20	X
Connecticut	11.5 (c, g)	1 to 14 (d)	8	20 (e)	40	X
Georgia	6	1 to 6	4 (a)	7.5 + 3% of retail	12	X
Hawaii	4.4 to 6.4	2 to 10	4	16 to 22.5	40% wholesale	
Idaho	8	2 to 8.2	5	18	18	X
Illinois	4 (p)	2.5	5 (a, e)	13	20	X
Indiana	3.4 (f)	3.4	5	15	15.5	X
Iowa	6 to 12 (F, h, q)	.4 to 9.98 (F, q)	4 (a)	20	31	
Kansas	4.5 (g)	3.65 to 8.75 (F, n)	4.25 (a)	15 (e)	24	X
Kentucky	3 to 7.25	2 to 6 (F)	5 (a)	15 (l)	3.001	X
Louisiana	4 to 8 (F)	2 to 6 (F)	4 (a)	16	16	
Maine	3.5 to 8.93 (q)	2 to 8	5	17	28	X
Maryland	7	2 to 5	5	18.5	13	X
Massachusetts	(j)	5 (k)	5	11 (l)	26	X
Michigan	2.35	4.6	4	15	25	X
Minnesota	9.5 (q)	6 to 8.5 (o, q)	6 (a)	20	38	X
Mississippi	3 to 5	3 to 5	6	18 (b)	18	
Missouri	5 (F, c)	1.5 to 6 (F)	4.225 (a, b)	11	13	X
Nebraska	4.75 to 6.65	3.1 to 4.8 (q)	4 (a)	22.3 (l)	27	
New Jersey	9 (g)	2 to 3.5	6	10.5	27	X
New Mexico	4.8 to 7.6	1.8 to 8.5	4.75 (a)	16.2	15	X
New York	9 (c, q)	4 to 7.875 (b, r)	4 (a)	8	33	
North Carolina	7	3 to 7	3 (a)	15.7 (l)	2	X
North Dakota	3 to 10.5 (F, q)	3.24 to 14.57 (F, h, m)	6	20	30 (b)	X
Ohio	5.1 to 8.9 (c)	.743 to 6.9	5 (a)	15.1 (l)	18	X
Oklahoma	5	.5 to 10 (F, n)	4 (a)	16	23	
Pennsylvania	8.5	2.1	6	12	18	X
Rhode Island	9	22.96% of Federal income tax	6	20 (l)	35	X
South Carolina	5	2.75 to 7	5	16	7	X
Tennessee	6	6 (d)	5.5 (a)	20	13	
Utah	5	2.6 to 7.35 (F, h)	5.094 (a, b)	19	23	X
Vermont	5.5 to 8.25	25% of Federal income tax	4	16 (b)	17	X
Virginia	6 (c)	2 to 5.75	3.5 (a)	17.5	2.5	X
West Virginia	9.45 (b)	3 to 6.5 (q)	6	15.5	17	
Wisconsin	7.9	4.9 to 6.93 (q)	5 (a)	20.8 (l)	30	X
Florida	5.5 (q)		6 (a)	4	24	X
Nevada	These 5 states	These 7 states	5.75 (a)	16.25	15	X
South Dakota	have no	have no	4 (a)	18	23	
Texas	corporate	individual	6 (a)	15	26	
Washington	income tax	income tax	6.5 (a)	18	34 (b)	X
Wyoming			3 (a)	9	12	X
Alaska	1 to 9.4 (q)		These	8	16 (e)	X
Delaware	8.7	3.2 to 7.7	5 states	16	14	
Montana	6.75 (g, s)	2 to 11 (F)	have no	20	16 (e)	X
New Hampshire	8	5 (d)	general	14	21	X
Oregon	6.6	5 to 9 (F, h)	sales tax	16 (e)	27	X

(X) Indicates state levies a property tax.
(F) Allows Federal income tax as a deduction.

(a) Local taxes are additional.
(b) Future reduction scheduled under current law.
(c) Alternative methods of calculation may be required.
(d) In Connecticut, New Hampshire, and Tennessee, rates apply to income from interest and dividends only. Capital gains are taxed at 7% in Connecticut.
(e) Future increases scheduled under current law.
(f) A supplemental net income tax is imposed at 4.5%.
(g) Corporate surtax is imposed: Connecticut, 20%; Kansas, 2.25%; Montana, 4%; New Jersey's rate is .375% beginning July 31, 1989.
(h) Deductions limited.
(j) Excise tax is imposed equal to the greater of $400; or the sum of a tax on net worth or the value of tangible property not taxed locally, plus 9.5% of net income.
(k) Tax of 10% on income derived from intangibles, and 5% on all other income.
(l) Tax rate is periodically adjusted administratively.
(m) Optional tax of 17% of taxpayer's adjusted Federal income tax liability.
(n) In Kansas and Oklahoma the higher rates apply to taxpayers deducting Federal income tax.
(o) Additional tax is imposed on income over specified levels, varying with filing status.
(p) Additional 2.5% personal property replacement tax.
(q) Alternative minimum tax is imposed.
(r) Qualified taxpayers may elect to pay alternative taxes at varying rates.
(s) 7% rate for corporations using water's edge apportionment.

Source: Compiled by Tax Foundation from data reported by Commerce Clearing House through June 15, 1989.

Sales Taxes Garner Most Revenue for States

General sales taxes produced more revenue for the states than any other source, according to recent analysis by the Tax Foundation. Economists at the Washington-based tax watchdog organization say that in the 45 states which levy general sales taxes, $87 billion was brought into state treasuries in fiscal year 1988 — almost a third (32.9 percent) of the $264.1 billion total state tax collections for that year.

The personal income tax ranked a close second, bringing in $80.1 billion during fiscal 1988 for 30.3 percent of total tax receipts, a 5.4 percent increase over 1987's take. Corporate income taxes, the third largest single tax source, increased 4.8 percent, amounting to $21.7 billion or 8.2 percent of the total. Only five states (Nevada, South Dakota, Texas, Washington, and Wyoming) have neither a corporate nor a personal income tax, and only seven states (the previous five plus Alaska and Florida) have no individual income tax.

All states tax gasoline and motor fuels. A sizable 9.6 percent increase here netted $17.2 billion, 6.5 percent of states' total taxes in fiscal 1988.

Local property taxes are also levied in all 50 states, and 39 states have some form of property tax; 39 states have both general sales and income taxes; and 33 states have general sales, income, and property taxes, Tax Foundation economists say.

1989 Tax Rates

Sales Taxes

Connecticut leads the list of top rates with its 8 percent sales and use tax rate, followed by: Washington (6.5 percent); Florida, Minnesota, Mississippi, New Jersey, North Dakota, Pennsylvania, Rhode Island, Texas, West Virginia (6 percent); and Nevada (5.75 percent). No state general sales tax is levied in Alaska, Delaware, Montana, New Hampshire, or Oregon, although municipalities in Alaska do impose sales taxes.

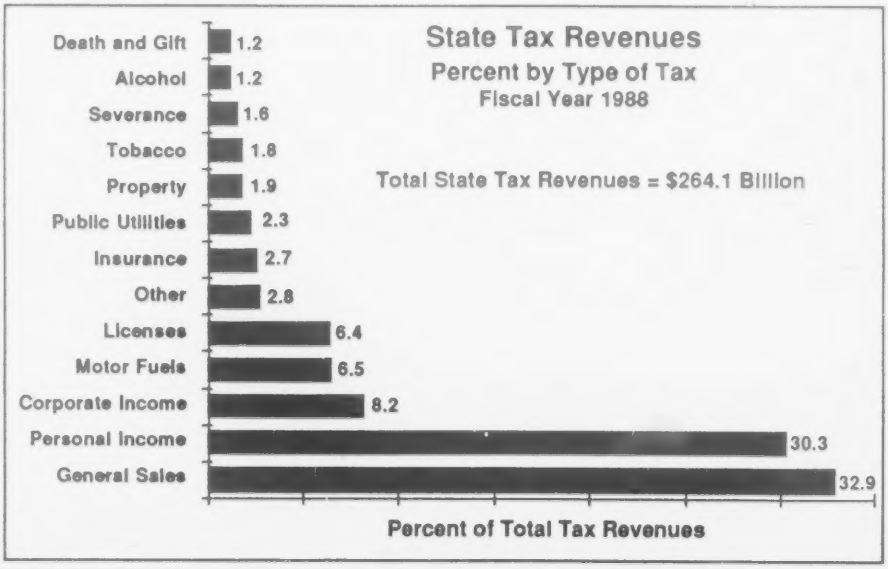
The state sales tax is lowest — 3 percent — in three states: Colorado, North Carolina, and Wyoming. Localities in 29 states levy sales taxes, generally in addition to those shown in the accompanying table.

Income Tax Rates

The tax rate schedules are progressive in all but six of the 43 states that levy a personal income tax. Colorado, Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania apply a flat rate, regardless of income level. In two states, income taxes are levied as a percentage of Federal individual income tax obligations — Rhode Island and Vermont.

The maximum corporate income tax is highest in Iowa (12 percent), Connecticut (11.5 percent), and Arizona and North Dakota (10.5 percent).

(See STATE TAXES on page 8)



THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

A Parting Shot

This will be my last Front Burner as President of the Tax Foundation. Over the years this column has covered a wide variety of subjects, trying to provide some insight into basic, critical issues. I have been rewarded with a heartening flow of feedback — pro and con — from many of you, and I thank you.

Before handing the reins to my successor I want to make one last observation from this vantage point. We as a people who make up this American society have gone slightly "nuts" on the little-child cult of security guaranteed by government. In short, we are turning into a nation of parasites.

It is all based on the illusion that we can vote ourselves rich. We cannot. Citizens are only fooling themselves if they believe that "social security" rests on the promises of politicians rather than on the character, competence and courage of individual men, women, and families.

It will be one of the great frauds of history if we let ourselves be led to believe that the output of any society can be greater than the input of its individuals. Ask Mikhail Gorbachev about that.

It will be one of the ironies of history if we slip into the swamps of collectivism, just as the rest of the world is fighting, and dying, to climb back out.

(STATE TAXES from page 7)

Gasoline Tax

Taxes on motor fuels have increased faster than any category of state tax over the last year. Gasoline rates are currently highest in Nebraska (22.3 cents a gallon); Wisconsin (20.8 cents); and Hawaii (where combined state-local rates range from 16 to 22.5 cents per gallon). The lowest rate, 4 cents, is levied in Florida, where gasoline is also subject to the general sales tax. The next lowest rate — 8 cents — applies in Alaska and New York.

Cigarette Tax

Cigarette taxes also make a notable contribution to state tax revenues, Tax Foundation economists report. In fiscal 1988, the states collected $4.6 billion of their total taxes from tobacco product excises. Current rates range from a high of 40 cents a pack in Connecticut to a low of 2 cents in North Carolina.

The table on page six gives details, as of July 1, 1989 for major taxes and rates employed by the states.

State Government Tax Collections By Type

Fiscal Years 1987-1988
($Billions)

Type of Tax	1987	1988	Percent Change 1988	Percent of Total 1988
Total	$ 247.0	$ 264.1	6.9%	100.0%
General Sales	79.6	87.0	9.3	32.9
Personal Income	76.0	80.1	5.4	30.3
Corporate Income	20.7	21.7	4.8	8.2
Motor Fuels	15.7	17.2	9.6	6.5
Licenses	16.0	17.0	6.3	6.4
Other	7.3	7.4	1.4	2.8
Insurance	6.4	7.0	9.4	2.7
Public Utilities	6.0	6.2	3.3	2.3
Property	4.6	5.0	8.7	1.9
Tobacco	4.6	4.8	4.3	1.8
Severence	4.0	4.3	7.5	1.6
Alcohol	3.1	3.2	3.2	1.2
Death and Gift	3.0	3.2	6.7	1.2

Source: Department of Commerce, Bureau of the Census; and Tax Foundation.

Tax Foundation's
"Tax Burden by Income Class 1986-1987"

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FEDERAL TAX POLICY MEMO

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MAY/JUNE 1989

Principles of Taxation
"In Light of Modern Developments"

In *The Wealth of Nations*, written in 1776, Adam Smith set down four principles which he felt should guide the making of tax policy. They bear repeating:

I The subjects of every State ought to contribute toward the support of the Government as nearly as possible in proportion to their respective abilities, i.e. in proportion to the revenue which they respectively enjoy under the protection of the State.

II The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person.

III Every tax ought to be so levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it.

IV Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State.

These maxims have proven remarkably resilient through the years as basic standards to uphold in public finance. New economic and social developments, of course, do condition the public policy response. The noted British economist, Sir Josiah Stamp, called Smith's principles "indisputable", but said they were "inadequate to the practical task of bringing under judgement the many different issues that confront us." Stamp attempted to recast and enlarge on Smith's standards in his own work, *The Fundamental Principles of Taxation in the Light of Modern Developments*. This was penned in 1920. Among other things Stamp wanted to explain progressive taxation which Adam Smith's first principle appeared not to endorse.

Almost 70 years later we are still busy recasting and that is inevitable given the growth and diversity of market economies. But attention to basic principles is more important than ever because there are so many more opportunities to stray from them in a world of accelerating tax legislation and regulation.

In modern times Adam Smith's principles of taxation have been regrouped into three broad objectives:

(1) Equity
(2) Simplicity
(3) Efficiency

Equity among taxpayers was Smith's first point and remains cardinal. Simplicity combines the objectives of certainty and convenience — the administrability of tax matters for both the tax collector and taxpayer. Efficiency in collection of taxes — Smith's fourth point — has taken on a much larger meaning. Now, not only does this mean that taxation should not distort the workings of market economies but, to many observers, it is extended to mean that tax policy should actively promote economic growth.

There can be tension between these objectives. Overemphasis on one can diminish another. The best recent example of this in the U.S. was the Tax Reform Act of 1986 in which the pursuit of a more equitable income tax system ran roughshod over simplicity — and some would say over efficiency too. At the outset of the last round of tax reform, the objective of tax simplification was considered very important. The title of the 1984 Treasury Department report was *Tax Reform for Fairness, Simplicity and Economic Growth*. During subsequent consideration of the actual reform legislation, however, simplification dropped by the wayside. For many individual and corporate taxpayers the end result was a staggering increase in complexity and their tax administrative burden.

Furthermore, there is substantial disagreement among policy makers as to what actually makes for an equitable and efficient tax system. In the more than 200 years since the *Wealth of Nations*, the case for progressive taxation with graduated rates of tax or other means to impose a relatively heavier burden on upper income groups has become well ingrained. However, it has always been an uneasy case because of the lack of a truly objective standard — such as arithmetic proportion — and the doubtful application of progression to the universe of individual and business taxpayers. Therefore, in taxation, as in other aspects of public policy, fairness is often defined in the eye of the beholder. And as for efficiency, this is too often defined by whose econometric model is being used and by what interest group.

The Tax Foundation believes it is important to set forth an *explicit* and *consistent* set of principles to guide policy makers; principles that are instructive in terms of making actual policy choices "in the light of modern developments." The major concepts of equity, simplicity and efficiency are obviously evident throughout the list shown on page two.

The first five principles focus on tax certainty and taxpayers' ability to comply, which we believe need reemphasis in the wake of the 1980s' legislative onslaught. Principles six though nine relate to tax policy and economic efficiency, both domestic and international, and principle ten applies one through nine to the whole Federal system.

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TAX FOUNDATION
PRINCIPLES OF TAXATION

(1) A good tax system requires informed taxpayers. It should be clear to the taxpayer **who** and **what** is being taxed and how tax legislation is enacted.

(2) The tax system should be as simple as possible, easy to understand, and easy to comply with. Compliance expense is a cost to society, and complicated taxation undermines voluntary compliance.

(3) Stability is important. The tax law should not change continually. Regulations should be issued promptly after legislation is enacted but frequent change makes this impossible.

(4) Changes in the tax law should not be retroactive. Taxpayers should be able to rely with confidence on the law as it exists when they enter a transaction.

(5) Tax legislation should be based on sound legislative procedures and careful analysis. There should be open hearings with full opportunity to comment on legislative and regulatory proposals. Revenue estimates should be fully explained.

(6) The primary purpose of taxes is to raise needed revenue, not to micromanage the economy with subsidies and penalties. The tax system should aim for neutrality in economic decision making and minimize distortions of the free market. The tax system should not favor consumption over savings and investment (or vice versa).

(7) It makes a difference how large a share of GNP is taken by the government in taxes because the taxpaying private sector generates the wealth that determines our standard of living. It makes a difference how we define the tax base because we burden the activities included in the tax base.

(8) Taxes should be broadly based and rates of tax should be moderate at all points.

(9) As we live in a global marketplace, the U.S. tax system must be competitive with those of other industrialized nations. The U.S. tax system should not impede the free and fair flow of goods, services and capital. It should not penalize imports, exports, U.S. investment abroad, or foreign investment in the U.S.

(10) State taxes are an important factor in our Federal system. The same general policies that apply to Federal taxes should also apply to State taxes. Federal and State tax systems should be harmonized to the extent possible.